S CORPORATIONS UPDATE OCTOBER 2011

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INADVERTENT TERMINATION

Recent Private Letter Rulings

Section 1362(f) permits the IRS to ignore a terminating event if certain conditions are met. The IRS must agree that the termination was inadvertent; steps must be taken to correct the situation within a reasonable time after discovering the terminating event ; and the corporation and all shareholders must agree to make corrective adjustments required by IRS consistent with treatment of the corporation as an S corporation. The IRS has been very reasonable when issuing private letter rulings concerning inadvertent termination status. The following are several of the recent letter rulings.

Ineligible Shareholders.

In Letter Ruling 201046005, IRS granted inadvertent termination status when an S corporation inadvertently issued shares to an IRA, an ineligible shareholder. Upon discovery of the problem, the corporation took remedial action by redeeming all of the shares that it had transferred to the IRA. During the period from the inadvertent termination to the redemption of the IRA shares the S corporation reported a net loss. The ruling granted inadvertent termination status but required the IRA to be treated as the shareholder during the loss period.

Letter Ruling 201103015 involved a situation where a limited liability company (LLC) purchased all the shares of an S corporation. Upon discovery that the LLC was not a permitted shareholder, the LLC distributed all its S corporation shares to its members in proportion to their ownership interests. However, there were 15 trusts which were members of the LLC. The trusts could qualify as Electing Small Business Trusts (ESBTs) but they had not made the required election. The corporation represented that there was no intention to terminate the S corporation status and that the transfer of stock to the LLC was inadvertent and not motivated by tax avoidance or retroactive tax planning. Based on the facts submitted and representations made, IRS concluded that the election terminated when the LLC acquired the stock but this termination was inadvertent. In addition, to the extent the S corporation status would have terminated when the LLC distributed the corporation stock to the trusts, that was also considered inadvertent. Favorable inadvertent termination status was granted provided the trusts file ESBT elections to be effective retroactively within 120 days of the date of the letter and that all parties reported the S corporation income as if the S corporation status was not terminated.

Letter Ruling 201113017 involved an S corporation where some of its shares were transferred to a trust. The trust beneficiary did not file an election to treat the trust as a qualified Subchapter S Trust (QSST); nor did the Trustee file an election to treat the trust as an Electing Small Business Trust (ESBT) thus causing inadvertent termination of S corporation status. The advisor to the trust discovered the error and the S corporation shares owned by the trust were transferred to its beneficiary, an eligible shareholder. IRS concluded that the termination was inadvertent and the S corporation status could continue. The ruling did not state whether the trust would be required

to make any election. Presumably, the beneficiary would be treated as the shareholder during the period that the trust owned the stock.

Failure to File the Form 2553

Letter Ruling 201110008 involved a situation where the corporation did not file an S corporation election at all. The facts indicate that the company intended to file the Form 2553 but due to inadvertence, the election was never filed. Based on the facts submitted and representations made, IRS concluded that the company established reasonable cause for failing to make a timely S corporation election. Further, IRS ruled that if the corporation files a completed Form 2553 effective on the date that they intended it to be effective within 120 days following the date of the ruling, the election would be treated as timely made.

Excess Passive Investment Income

Letter Ruling 201110001 involved a situation where an S corporation had passive investment income exceeding 25% of its gross receipts for more than three years and it had C corporation accumulated earnings and profits for all of those years. As a result, its election terminated on the first day of the fourth year. The corporation represented that it had always intended to maintain its S corporation status, that the termination was inadvertent, and that there was no retroactive tax planning or tax avoidance. In addition, the corporation represented that it incurred losses in all the years at issue. IRS ruled that the termination would be ignored

provided that the corporation distributed all of its accumulated earnings and profits pro rata to its shareholders by a certain date
and that the shareholders report their pro rata shares of this distribution as dividends on their federal tax returns.

Disproportionate Distributions

Letter Ruling 201102033 involved an S corporation that made disproportionate distributions to its shareholders in certain taxable years. The corporation represented that under its governing provisions, all shares possessed identical rights to distribution and liquidation proceeds. The corporation further represented that neither it nor its shareholders knew that disproportionate distributions could terminate its S corporation status. The corporation will make remedial distributions to its shareholders to equalize their distributions upon the issuance of a favorable letter ruling. Based solely on the facts submitted and representations made, IRS concluded that *if* the corporation=s S corporation status was terminated for having more than one class of stock because of the disproportionate distributions, that the termination was inadvertent within the meaning of section 1362(f). Accordingly, the S corporation status termination would be ignored. The ruling is contingent upon the corporation making remedial distributions within 120 days of the date of the letter ruling.

Letter Ruling 201105017 involved an S corporation that paid state income tax on behalf of those shareholders who were not residents of the state in which it was incorporated. The corporation did not treat these payments as distributions to those shareholders but later recognized that these payments should have been treated as constructive distributions, which caused the distributions to its shareholders to be disproportionate. The corporation represented that it was not aware that failure to treat the tax payments as constructive distributions could cause the corporation to be treated as having more than one class of stock. It represented that it did not intend to terminate S corporation status and that the circumstances resulting in possible termination were not motivated by tax avoidance or retroactive tax planning. The corporation represents that it has taken or will take corrective actions to make remedial distributions correcting the effect of the potential disproportionate distributions. The ruling noted that Reg. '1.1361-1(l)(2)(ii) provides that state laws requiring a corporation to pay or withhold state income tax on behalf of some of its shareholders are disregarded in determining whether the outstanding stock confers identical rights to distribution and liquidation proceeds provided that when the constructive distributions are taken into account, the outstanding shares confer identical rights to distributions and liquidation proceeds. Further, differences in timing between the constructive distributions and the actual distributions to the other shareholders do not cause the corporation to be treated as having more than one class of stock. Based on the information submitted and representations made, IRS concluded that if the corporation had more than one class of stock its S corporation status would be terminated, but if that status was terminated, such termination was inadvertent and the corporation will be treated as continuing to be an S corporation.

PERMISSIBLE SHAREHOLDERS

Tax Exempt Organizations

Under section 1361(c)(6) an organization that is described in section 401(a) or 501(c)(3) that is exempt from tax under section 501(a) may be a shareholder in an S corporation for tax years beginning after December 31, 1997. Section 401(a) includes qualified stock bonus, pension, and profit sharing plans of an employer for the exclusive benefit of its employees or their beneficiaries. It does not include Individual Retirement Accounts (IRAs) described in Section 408.

The American Jobs Creation Act of 2004 created a limited exception to the general rule. It allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation but only to the extent of bank stock held by the IRA on the date of enactment, October 22, 2004. Letter Ruling 201113004 involved a corporation that had an IRA shareholder and made its S election prior to October 22, 2004.

At the time the election was made, it was invalid because of the IRA ineligible shareholder. After the October 22, 2004 effective date, the IRA was a permissible shareholder and the corporation requested a private letter ruling validating the invalid election on the grounds that it was inadvertently invalid. In granting the request, IRS conditioned the S corporation status upon the payment of tax based on the treatment of the IRA beneficiary as the shareholder from the date of election to October 22, 2004. The favorable ruling was also conditioned upon the corporation and its shareholders filing any original or amended returns within 120 days from the date of the letter ruling making adjustments necessary to properly reflect reporting of the S corporation=s income consistent with it being an S corporation.

LATE ELECTIONS

Private Letter Rulings

Code section 1362(b)(5) permits the IRS to consider a late S corporation election as timely filed if it is determined that there was reasonable cause for the failure to timely file the election. Several revenue procedures provide automatic consent under certain circumstances. Where those revenue procedures do not apply, it is necessary for taxpayers to apply for private letter rulings.

Among the recent rulings issued that permit S corporation status to be obtained where the election was not timely filed are Letter Rulings 201124002, 201124005, and 201124007. In each of these rulings, IRS held that the corporation intended to be an S corporation, the Form 2553 was not timely filed, but that there was reasonable cause for the failure to timely file. S corporation status was granted retroactively provided a Form 2553 would be filed within 120 days from the issuance of the private letter ruling. Unfortunately, as with most of the recent rulings, the IRS does not tell us what the reasonable cause was. These rulings merely state that based on the facts submitted and representations made, IRS concluded that reasonable cause existed.

However, in Letter Ruling 201123013, IRS held that reasonable cause did not exist and relief was not granted. In that ruling, the corporation originally intended to be a tax-exempt entity effective upon incorporation. After failing to complete the application to be a tax-exempt entity, the corporation decided to be an S corporation effective as of the date of incorporation. However, the Form 2553 was not timely filed. The corporation=s sole shareholder requested a ruling that the corporation be recognized as an S corporation effective as of the date of incorporation. IRS denied
relief in that situation, concluding that the corporation had not established reasonable cause for failing to timely make the election.

SALE OF S CORPORATION STOCK

Avoiding Tax on Gain

Kerman v. Commissioner, TC Memo 2011-54 (March 8, 2011), involved taxpayers who sold stock of an S corporation to an employee stock ownership plan for $6 million and recognized capital gain of $5.4 million. Attempting to avoid the tax liability on this gain, petitioners entered into a Custom Adjustable Rate Debt Structure (CARDS) transaction that generated a loss reported on their Form 1040. IRS disallowed the loss and imposed a 40% penalty under Code section 6662. The Tax Court found that the CARDS transaction lacked economic substance and stood no chance of earning a profit. The petitioners did not have a nontax business purpose for entering into the transaction. Because the Tax Court found that the transaction lacked economic substance, it was disregarded for tax purposes and the claimed loss was disallowed. Further, the petitioners failed to establish reasonable cause for the gross misstatement in the value of the basis of the foreign currency used in the CARDS transaction and so the section 6662 penalty was upheld.

ROTH IRAs

Excess Contributions

Hellweg v. Commissioner, TC Memo 2011-58 (March 9, 2011), involved shareholders of an S corporation who set up Roth IRAs. These IRAs formed a Domestic International Sales

Corporation (DISC) which entered into a commission agreement for DISC commissions on the S corporation=s qualified export sales. IRS allowed the transaction for income tax purposes but challenged it for excise tax purposes. For excise tax purposes only, IRS recharacterized commission payments from the S corporation to the DISC as distributions to petitioners followed by their contribution of the proceeds to their Roth IRAs. IRS claimed that each petitioner was liable for excise taxes on excess contributions to a Roth IRA under Code section 4973, accuracy related penalties under section 6662(a), and additions to tax under section 6651(a)(1).

Upon a Motion for Summary Judgment, the Tax Court ruled in favor of the petitioners on all counts. Because IRS allowed the transaction to stand for income tax purposes, it failed in its attempt to impose the excise tax penalty of Section 4973 for excess contributions to the Roth IRAs. *Ohsman v. Commissioner*, TC Memo 2011-98 (May 3, 2011), was a similar case involving a C corporation.

BUILT-IN GAINS TAX

Capital Loss Carryforwards

Code section 1374(b)(2) permits a deduction from the built-in gains calculation for net operating loss carryforwards arising in prior C corporation tax years. For purposes of this calculation, the amount of net recognized built-in gain is treated as taxable income. Rules similar to those rules are to be applied in the case of capital loss carryforwards arising in prior C corporation tax years.

A question has arisen with respect to the capital loss carryforwards because the wording of Reg. Sec. '1.1374-5(a) provides that loss carryforwards allowed as deductions against net recognized built-in gain are allowed only to the extent that they would be allowed under the rules applicable to C corporations. This rule does not allow other carryforwards such as charitable contribution deduction carryforwards to reduce recognized built-in gain. The question arises as to whether the use of capital loss carryforwards is limited because in a C corporation capital loss carryforwards can only offset capital gains. An argument can be made that this limitation should not apply to the calculation of built-in gains because Code section 1374(b)(2) provides that the rules for the capital loss carryovers are to be applied in a manner similar to the rules for net operating losses and in those cases the taxable income is deemed to be the amount of net recognized built-in gain. Under this theory, any net recognized built-in gains for this purpose would be treated as if they were capital gains, thus allowing the use of C corporation capital loss carryovers to reduce built-in gain regardless of whether there are capital gains included in the built-in gain taxable income.

LEGISLATIVE DEVELOPMENTS

Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

In December 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The new law extends for two years certain of the Bush tax cuts. The following changes affect S corporations and are discussed in this article.

Basis Adjustment for Charitable Contributions of Property

The temporary provision providing that an S corporation shareholder=s basis reduction in the stock of the S corporation caused by a corporation charitable contribution of appreciated property provides that the basis will be reduced only by the shareholder=s share of the corporation=s adjusted basis of the contributed assets. This was a temporary provision originally inserted in the Pension Protection Act of 2006 for tax years beginning after 2005 and before 2008. The provision was extended by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 for an additional two years - - 2008 and 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extends this for an additional two years - - 2010 and 2011.

Charitable Contributions of Food Inventory

The provisions relating to the charitable deduction for contributions of food inventory made by S corporations that were scheduled to expire for tax years beginning after 2009 were also extended for two years - - for 2010 and 2011 - - by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

PROPOSED LEGISLATION

S Corporation Modernization Act of 2011

The latest version of an S Corporation Modernization Act was introduced in the House of Representatives on April 12, 2011 and referred to the Ways and Means Committee. The proposal updates earlier versions of the proposed legislation and includes the following items:

1. The temporary reduction of the Section 1374 built-in gains tax recognition period to

five years for a tax year beginning in 2011 added by the Small Business Jobs Act of 2010 would become permanent;

2. For tax years beginning after December 31, 2010, excess passive investment income would no longer be a terminating event.

3. The passive investment income tax of Code section 1375 would not apply unless the passive investment income exceeded 60% of the gross receipts, instead of the present 25%.

4. Nonresident aliens would be allowed to be potential current beneficiaries of an Electing Small Business Trust (ESBT);

5. Individual retirement accounts including Roth IRAs would be permitted to be shareholders of S corporations;

6. Sales of stock in an IRA relating to S corporations would be exempt from the prohibited transaction rules of section 4975 if certain conditions were met;

7. Electing small business trusts (ESBTs) would be permitted a deduction for charitable contributions effective for taxable years beginning after December 31, 2010;

8. The rule regarding basis adjustments to stock of S corporations making charitable contributions of appreciated property would be made permanent for taxable years beginning after December 31, 2010.

Tax Return Due Date Simplification and Modernization Act of 2011

A Senate bill would change the due dates for corporations (C corporations and S corporations). Calendar year S corporation tax returns would become due on March 31 instead of March 15. Calendar year C corporation tax returns would become due on April 15 instead of March 15. The proposal would be effective for tax returns for tax years beginning after December 31, 2011. In addition, corporations would be permitted an automatic six month extension instead of the current three month extension for taxable years beginning after December 31, 2011.

S CORPORATION DIVIDENDS HELD TO BE COMPENSATION

Employment Taxes Due

The IRS recharacterized S corporation dividends paid to David E. Watson from his S corporation as salaries, subject to payroll taxes for each of the eight calendar quarters in 2002 and 2003. Watson made a payment on one of the quarters, filed a refund claim that was denied, and then filed an action in the District Court for the Southern District of Iowa.

The District Court denied Watson=s Motion for Summary Judgment on the issue whether payments to Watson should be recharacterized as salary, 714 F. Supp. 2d 954 (Dist. Ct. Iowa 5/27/10). The denial was rendered because there was clearly a genuine issue of material fact that needed to be decided before a judgment could be issued. On December 23, 2010, the court entered an order after a bench trial concluding that the Plaintiff=s $24,000 salary in 2002 and 2003 was unreasonably low, 757 F. Supp. 2d 877 (Dist. Ct. Iowa, 12/23/10). The recharacterization of $67,044 in dividend payments to Watson for each of those years was amply supported by the evidence resulting in an annual salary of $91,044 and was held to be reasonable on the specific facts and circumstances of this case. The court appeared to rely heavily on the government=s expert. The expert, in turn, relied on annual statement studies from the Risk Management Association, a survey published by the University of Iowa regarding starting salaries for new accounting graduates, compensation data from Robert Half International (a placement agency for individuals in accounting and finance), and a portion of the Management of an Accounting Practice survey conducted by the American Institute of CPAs, relevant specifically to the Iowa Society of CPAs.

BASIS ADJUSTMENTS WHEN DISTRIBUTIONS ARE MADE

Apparent Error By IRS S Corporation Technical Advisors

An interesting question arises with respect to the treatment of carryover losses and deductions that were disallowed in prior years due to the basis limitation. Informal discussions with IRS S corporation technical advisors indicate that the IRS does not follow the provision of Code section 1366(d)(2)(A) which states that any loss or deduction that is disallowed for any tax year because of the basis limitation on losses and deductions of section 1366(d)(1) Ashall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.@ In the

IRS view, such losses and deductions are always treated separately from the same type of subsequent year items. The controversy can be illustrated by the following examples.

Example 1: Kenneth is the sole shareholder of an S corporation on January 1, 2010. His

basis for the stock is zero. He has made no loans to the corporation. During 2010, the corporation has business income of $10,000 and business expenses amounting to $4,000. The corporation makes a distribution to Kenneth of $7,000. There is no dispute about the answer to this question. The business income and expenses, having occurred in the same year, are netted resulting in a basis increase of $6,000. The distribution of $7,000 results in a zero basis at the end of the year and a $1,000 capital gain to Kenneth.

Example 2: Consider the same example except that the $4,000 business expenses occurred in 2009 and were not deductible in that year because Kenneth had a zero basis in his stock and no loans to the corporation. In this situation IRS ignores the section 1366 requirement to treat the business expense loss as having been incurred in the succeeding taxable year with respect to Kenneth and instead would increase basis by the business income of $10,000 then, treat the distribution of $7,000 as being tax free because of the sufficient basis, reducing the basis to $3,000. Then $3,000 of the $4,000 business expenses would be deducted in that year by Kenneth and $1,000 of the $4,000 business expenses would be carried over by him to tax year 2011.

The IRS personnel point to Regulation ' 1.1366-2(a)(3)(i) as authority for their conclusion. The sentence they point to in that paragraph dealing with the stock basis limitation amount is the following:

> AIn so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2)(B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year.@

They missread the foregoing sentence to maintain that losses and deductions from a prior taxable year should be treated differently from losses and deductions of the current year. The parenthetical material dealing with prior year losses is to remind the reader that losses and deductions includes those previously disallowed that are carried over to the current year.

It appears that the IRS understanding of this section is inaccurate. However, at the present time, no conclusive authority appears with respect to either conclusion.

Further developments have occurred with respect to the question of whether suspended losses from a prior year are considered separately from similar type losses for the current year in determining basis of S corporation stock when distributions are made. As indicated above, IRS technical advisors have informally indicated that they believe suspended losses and deductions should be treated differently from current losses and deductions when calculating stock basis in years that distributions are made. In a letter dated May 23, 2011, the President of the New York

State Society of CPAs submitted comments advising the IRS of the correct interpretation of the regulations. The Chair of the the Tax Section of The Florida Bar in a letter dated June 15, 2011 agreed with the conclusion stated by the New York State Society of CPAs letter. The Chair of the FICPA Federal Tax Committee sent a similar letter on September 12, 2011 and the AICPA Tax Executive Committee sent a letter dated October 20, 2011.

State tuned for further developments.

QUALIFIED SUBCHAPTER S SUBSIDIARY

Special Rule for Banks

In an Action on Decision (AOD 2010-006) appearing at 2010-52 IRB (December 27, 2010) the IRS acquiesed in result only to the Seventh Circuit reversal of the Tax Court in *Vainisi v. Commissioner*, 599 F3d 567 (7th Cir., 2010) rev=g 132 TC 1 (2009).

Banks that hold qualified tax exempt debt obligations are subject to a 20% interest expense disallowance rule under Code section 291. However, Code section 1363(b)(4) provides that the 20%

disallowance rule of Code section 291 will only apply to an S corporation if it was a C corporation for any of the three immediately preceding taxable years. The question here involved whether a QSub bank is to be treated the same way as an S corporation bank for this purpose.

The Tax Court held for the government, and the Seventh Circuit reversed holding for the taxpayer. The latest item is the IRS Action on Decision indicating acquiescence in result only.

FAILURE TO INCLUDE S CORPORATION INCOME ON FORM 1040

Receipt of Income Not Required

In *Hill v. Commissioner,* TC Memo 2010-268 (December 8, 2010), the Tax Court held that Mr. Hill failed to report his pro rata share of ordinary income from an S corporation on his Form 1040. Hill argued that he was not required to report the income because he did not receive any distributions from the S corporation in those years. He lost on that issue.

Tax Court Jurisdiction

In addition, Hill almost lost the chance to litigate in the Tax Court because he did not file a Form 8082. Failure to file that form can deprive the Tax Court of jurisdiction because the failure to notify the IRS of the inconsistency is treated as a mathematical or clerical error, not subject to Tax Court jurisdiction. However, there were other items on the Notice of Deficiency that did give the Tax Court jurisdiction.

LISTED TRANSACTIONS

Fifth Amendment Privilege

In connection with a refund suit involving the listed transaction S corporation strategy, the question arose as to whether an employee of KPMG who was part of a team that developed, marketed, sold and implemented most of this type of strategy would be able to invoke his Fifth Amendment privilege against answering questions. *Santa Clara Valley Housing Group, Inc. v. United States,* (106 AFTR 2d 2010-7370), a District Court for the Northern District of California decision dated December 14, 2010, held that the KPMG employee could not be compelled to testify. In this case, it was a taxpayer and not the government that sought the testimony. The court held that the Fifth Amendment privilege against self-incrimination does not depend upon the likelihood of prosecution, but instead depends upon the possibility of prosecution. Since the strategy was categorized as an Aabusive tax shelter@ and a listed transaction in Notice 2004-30, 2004-17 IRB 828 (April 26, 2004), there was a possibility of prosecution.

S Corporation Charitable Contribution Strategy

Santa Clara Valley Housing Corp., Inc., et al. v. United States of America, 108 AFTR 2d 2011-6361, (Dist. Ct. Northern District of California, September 21, 2011) involved Motions for Summary Judgment filed by the government, a shareholder, and the corporation involved in the S Corporation Charitable Contribution strategy.

Under that strategy, the S corporation shareholders temporarily transfer most of their stock to a tax exempt charitable entity that is not subject to the unrelated business income tax (UBIT) as a charitable contribution. Because the S corporation annual income flows through to its shareholders on a pro rata basis, the effect of that transfer is to render most of the corporation=s income exempt from income tax. The donated shares remain parked in the charity for a predetermined period of time. During this period the S corporation=s income accumulates in the corporation; distributions are minimized or avoided. After the predetermined period has elapsed, the charity sells the donated shares back to the original shareholders. This avoids income tax for income allocated to shares that were held by the charity and the accumulated income of the S corporation may later be distributed to the original shareholders either tax free or at favorable long term capital gains rates.

The original shareholders retain control over the corporation by donating only non-voting stock while retaining all shares of voting stock. Moreover, to protect against the possibility that the charity might refuse to sell its majority stock back to the original shareholders after the agreed upon length of time, warrants are issued to the original shareholders prior to the donation. These warrants enable the original shareholders to purchase a large number of new shares in the corporation. If exercised, the warrants would dilute the stock held by the charity to such an extent that the original shareholders would end up owning approximately 90% of the outstanding shares. Thus, the warrants allow the original shareholders to keep their equity interest in the corporation even though the charity appears to be the majority shareholder. This has been designated a listed transaction. IRS has advanced two separate and alternative legal theories to support the conclusion that it should not work.

Under the first theory, IRS contends that the transaction lacks substance and should be disregarded for tax purposes. Thus, the original shareholders would be taxed on the corporation=s income. IRS issued a Notice of Deficiency against the former shareholders for more than $4,000,000 for tax years 2000 through 2003.

Under the second theory, IRS contends that the warrants issued in connection with the transaction violated the one class of stock requirement and automatically terminated the corporation=s S corporation status. Based on that theory, the corporation was subject to income tax as a C corporation. Accordingly, IRS issued a Notice of Deficiency against the corporation for more than $600,000 for the 2000 tax year.

The corporation and the shareholders paid the deficiencies asserted by IRS and sought refunds plus interest and attorneys= fees in the instant action. The government and the corporation filed cross motions for summary judgment as to the government=s second theory, that the issuance of warrants resulted in termination of S corporation status. A shareholder filed

a Motion for Summary Judgment as to her refund claim, asserting that the bulk of the corporation=s income
flowed through to the charity and that her tax returns for the years 2000 through 2003 should not reflect the portion allocated to the charity.

The District Court cited Regs. '1.1361-1(l). These regulations treat the warrants as a second class of stock because: (1) they constitute equity or otherwise result in the owner of the warrants being treated as the owner of stock under general principles of federal tax law; and (2) a principal purpose of issuing the warrants was to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock.

The District Court concluded that the warrants did constitute a second class of stock because they were obviously designed to permit the family to retain nominal ownership of approximately 90% of the corporation even though 90% of the actual shares were donated to the charity. If the charity refused to sell the shares back, the family could exercise the warrants, thereby diluting the charity=s ownership so that the charity would go from owning 90% of the stock to approximately 10% of the outstanding shares. Thus, the court concluded that the warrants did constitute equity and were intended to prevent the charity from enjoying the rights of distribution or liquidation that ordinarily would come with ownership of the majority of a successful company=s shares. Accordingly, the court granted partial summary judgment in favor of the government that the warrants were a second class of stock causing termination of the S corporation status. Thus, the corporation would be liable for tax on all of the income, including the amount previously allocated to the charity.

Because the S corporation status terminated, the shareholder was entitled to a refund of deficiencies and penalties relating to allegedly unreported S corporation income after June 2000.

The only factual issue remaining to be decided was the government=s disallowance of the shareholder=s claimed charitable contribution deduction for the donation of the shares to the charity. That is a triable issue of fact and so the Motion for Summary Judgment was denied as to that portion of the case.

MANAGEMENT FEE TO RELATED CORPORATION DISALLOWED

Necessary or Reasonable

In *Weekend Warrior Trailers, Inc. v. Commissioner*, TC Memo 2011-105 (May 19, 2011), the sole shareholder of an S corporation formed another S corporation to manage the affairs of the initial S corporation. The stock of the second corporation was sold to an employee stock ownership plan (ESOP). IRS disallowed the management fees paid to the ESOP owned S corporation. IRS claimed there was no business purpose for the transaction, that it lacked both economic substance and economic purpose and was formed for the primary purpose of obtaining tax benefits. IRS also claimed that the inter-company transactions should be disregarded for federal income tax purposes

because they lacked economic substance and economic purpose and were entered into for the primary purpose of obtaining tax benefits.

The Tax Court held that the ESOP owned S corporation should not be ignored because all of the corporate formalities were followed. However, the Tax Court disallowed the deductions for management fees, conceding that the expenses were ordinary, but contending that the payments were not necessary or reasonable. The court agreed with the IRS because the record was vague as to what specific services the management company performed for the other company and who exactly performed these services.

LOANS FROM S CORPORATIONS TO SHAREHOLDERS

Malpractice Claim by Client of CPA Firm

Between 1994 and 2003, the sole shareholder of an S corporation withdrew varying sums of money from the corporation=s account which were recorded as ALoan to Officer@ on the company=s books. When the corporation hired a CPA to file its Forms 1120S for 2003 and 2004, the accounting firm found an asset listed on the 2002 tax return balance sheet of over $1,000,000 of shareholder loans. When the firm found that there was no documentation for the loans, no plan to repay, and in fact that the shareholder did not have the ability to make any repayment, the CPA firm advised the S corporation and its sole shareholder to amend their 2002 returns to treat the $1,000,000 loan receivable as a salary payment to its sole shareholder. The shareholder hired two tax attorneys for advice on the issue but ultimately authorized the defendant CPA firm to amend the 2002 personal and corporate tax returns consistent with the advice given. IRS accepted the amended 2002 returns and issued an assessment for more than $500,000. Defendants prepared and filed the corporate tax returns and the shareholder=s individual tax returns for 2003, 2004, and 2005. In 2008, Plaintiffs filed re-amended 2002 corporate and personal tax returns, again classifying the approximately $1,000,000 as a loan and reducing the sole shareholder=s compensation by that amount. The re-amendment caused the IRS to release the federal tax lien of approximately $500,000 against the shareholder.

The shareholder and the corporation filed a law suit against the CPA firm claiming that the defendants negligently advised them with respect to the ALoan to Officer@ account and that they suffered various damages as a result. The United States District Court for the District of Massachusetts granted Defendant=s Motion for Summary Judgment in *RTR Technologies, Inc., Rosalee Berger, and Craig Berger, Plaintiffs v. Carlton Helming and Helming & Co., P.C. Defendants*, Mass. Dist. Ct., 9/11/2011.

Defendants= Motion for Summary Judgment was granted for several reasons. First, the law suit was filed after the statue of limitations had expired. Second, the Complaint was insufficient to demonstrate damages. Thirdly and most importantly, the court stated: AIt is clear that Plaintiffs for many years enjoyed over $1,000,000 in income without paying any taxes on it, and they accomplished this by filing a tax return that improperly characterized the monies they received as a loan. It is close to ludicrous to claim that, by advising Plaintiffs to amend the 2002 tax return to conform with what the law and good accounting practice required, Defendants were being negligent. On the contrary, they were serving their clients ethically and well.@

LIMITATIONS ON LOSSES PASSING THROUGH TO SHAREHOLDERS

Basis Limitation

In *Broz v. Commissioner*, 137 TC No. 5 (September 1, 2011), the Tax Court held that shareholders did not have sufficient basis in their S corporation stock when payments were made to their S corporation with loan proceeds from a bank loan. Petitioners claimed that these were part of a back-to-back loan arrangement. The Tax Court held that the petitioners have not established

that they lent, the bank loan proceeds to their S corporation and that petitioner never substituted himself as Alender@ in place of the bank. As a result, the petitioners could not deduct the losses in that year.

At Risk Limitations:

Code section 465 limits the deductibility of losses by S corporation shareholders to the amount at risk. *Broz v. Commissioner,* 137 TC No. 5 (9/1/2011) also dealt with the issue of whether the pledging of stock of a related corporation would be sufficient to put petitioners at risk. The Tax Court held that it did not. The pledged property must be Aunrelated to the business@ if it is to be included in the taxpayer=s at-risk amount, said the Tax Court. Nor were petitioners at risk because they did not personally guarantee the bank loan and were never personally liable on the loans.

Passive Activity Loss Limitations

Under Code section 469(c)(7), rental activities of a taxpayer who is in the real property business (a real estate professional) are not automatically treated as passive activities but are treated as a trade or business subject to the material participation requirements of Code section 469(c)(1) and Regs. '1.469-9(e)(1). A taxpayer qualifies as a real estate professional (and therefore taxpayer=s rental real estate activities are not automatically passive) if he meets two requirements:

1. More than one-half of the personal services performed in trades or business by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and

2. The taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. In a joint return, these requirements are satisfied if either spouse separately satisfies the requirements.

In two recent cases, the Tax Court held that petitioners failed to establish that they met the 750 hour requirement to qualify as a real estate professional. The cases are *Bosque v. Commissioner*, TC Memo 2011-79 (April 4, 2011) and *Harnett v. Commissioner*, TC Memo 2011-191 (August 11, 2011).

DISTRIBUTIONS IN EXCESS OF BASIS

Calculation of Basis

Miller v. Commssioner, TC Memo 2011-189 (August 9, 2011), involved the issue of whether distributions taxpayer received from an S corporation exceeded his stock basis. In 2002, taxpayer had gifted 95% of his stock to his son. In 2003, taxpayer received large distributions, even exceeding those of the distributions made to his son. The issue of disproportionate distributions disqualifying S corporation status was not raised by either taxpayer or by the IRS. Instead, the Tax Court decision revolved around the issue of what the taxpayer=s basis was for the stock that he retained. The court found that the basis was less than the amount of the distributions and the excess was taxed to petitioner as long term capital gain.

VALUATION OF S CORPORATION

Tax Effecting

In the *Estate of Louise Paxton Galligher, Deceased et al. v. Commissioner,* TC Memo 2011-148 (June 28, 2011), the decedent owned 3,970 units of Paxton Media Group LLC. This represented a 15% ownership interest in the limited liability company that had elected to be taxed as an S corporation. In valuing the decedent=s ownership in the LLC units, the Tax Court opinion discussed the benefits of being taxed as an S corporation. Citing *Gross v. Commissioner,* the court noted that the principal benefit shareholders expect from an S corporation election is the reduction in the total tax burden imposed on the enterprise and that such savings ought not be ignored in valuing an S corporation. In using the discounted cash flow method of valuation, the Tax Court found that the S corporation benefit is properly reflected through the imposition of a zero-percent corporate tax rate in valuing the S corporation.

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