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Selected Issues in Operating an S Corporation

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SELECTED ISSUES IN OPERATING
AN S CORPORATION

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I. GENERAL

A. Introduction. One of the goals of subchapter S is to eliminate double taxation of corporate earnings. Subchapter S adopts a two-step approach in implementing this goal. First, subchapter S generally provides that the corporation itself is not subject to tax; rather, the tax items realized by the corporation are passed through to, and are reported by, the shareholders. Second, to avoid a second tax, subchapter S provides that distributions are generally tax free.

B. Overview of Shareholder-Level Consequences.

1. Distributions by S Corporation Without Accumulated Earnings and Profits. If an S corporation has no C corporation earnings and profits, the distribution is tax free to the extent of the shareholder’s basis in his stock. If the distribution exceeds the shareholder’s stock basis the distribution produces gain in the amount the distribution exceeds basis. IRC § 1368(b)(2).

2. Distributions by S Corporation With Accumulated Earnings and Profits. Distributions are treated as nondividends to the extent of the accumulated adjustment account ("AAA") balance, which represents undistributed subchapter S earnings, although such distributions produce taxable gain to the extent they exceed the shareholder’s stock basis. Distributions in excess of the AAA balance are treated as taxable dividends to the extent of accumulated earnings and profits. A distribution that exceeds both the AAA and accumulated earnings and profits is tax free to the extent of the shareholder’s stock basis; the distribution creates capital gain to the extent it exceeds the shareholder’s basis in his stock. IRC § 1368(c).

C. Overview of Corporate-Level Consequences of Noncash Distributions. Upon a liquidating or nonliquidating distribution of noncash property, an S corporation generally recognizes gain equal to the difference between the basis and fair market value of each property distributed. Any gain recognized by the S corporation generally increases the AAA and passes through to the shareholders, increasing the bases in their respective shares of stock. An S corporation does not recognize loss on a nonliquidating
distribution of property, but does recognize loss on a liquidating distribution of property. Any loss recognized by the S corporation generally reduces the AAA, passes through to the shareholders, subject to certain limitations, and reduces the shareholders’ bases in their respective shares of stock. IRC §§ 1371(a)(1), 311, 336, and 1367(a)(2)(B).

II. CONSEQUENCES OF DISTRIBUTIONS TO S CORPORATION

A. Distributions of Cash. S corporation does not recognize gain or loss on the distribution of cash. However a nondividend cash distribution reduces the AAA and, if the distribution constitutes a dividend, the distribution will reduce an S corporation’s accumulated earnings and profits. IRC § 1371(c)(3).

B. Nonliquidating Distributions of Property.

1. Property Distributions to Which Gain Recognition Rule Applies. An S corporation recognizes gain, but not loss, on the nonliquidating distributions of property under Section 311(b). The term "property" includes money, securities, and other property but excludes a corporation’s own stock or stock options. The gain recognition rule of Section 311(b) applies to distributions made "with respect to the stock" of the corporation and therefore applies to dividend distributions, distributions in redemption of stock and distributions in partial liquidation.

2. Consequences of Applicability of Gain Recognition Rule. If Section 311(b) applies, the corporation is deemed to have sold the distributed property to the shareholders at fair market value. The gain recognized by the corporation is generally passed through to the shareholders in proportion to their stock ownership, increasing the bases in their stock.

A former C corporation’s distribution of appreciated property can have troublesome consequences under the built-in gain rules of Section 1374. A corporate level tax (in addition to a tax on the gain passed through to the shareholders) can be imposed upon the gain arising from an S corporation’s disposition of certain property. IRC § 1374.

3. Distributions of Depreciated Property. The disposition of depreciated property in a nonliquidating distribution generally does not trigger the recognition of loss. Because a shareholder will take a fair market value basis in property distributed to him, a nonliquidating distribution of depreciated property generally results in a step down in the basis of
the distributed property, with no tax benefit for the reduction in basis. The step-down in basis without loss recognition can be avoided if the loss property is sold and cash is distributed. However, losses realized with respect to sales of assets between the corporation and certain shareholders may be disallowed. IRC § 267.

C. **Distributions in Complete Liquidation.** The liquidation provisions governing C corporations also govern the liquidation of an S corporation. The principal difference between liquidating and nonliquidating distributions is that the recognition of loss with respect to nonliquidating distributions is not permitted, while loss may generally be recognized on liquidating distributions. IRC § 311, 336, 336(d)(1).

D. **Accumulated Earnings and Profits — In General.** Although earnings and profits do not arise under subchapter S since 1982, an S corporation may have earnings and profits accumulated in pre-1982 years as well as in years during which the corporation was a C corporation or through various corporate transactions. IRC § 381(c)(2), 1371(a)(1). Under Section 1371(c)(1), the accumulated earnings and profits of an S corporation are generally not adjusted during the period the corporation is an S corporation.

1. **Adjustment for Distributions.** One exception to the general rule is that the portion of a distribution taxable as a dividend under Section 1368(c)(2) reduces the accumulated earnings and profits of an S corporation. Presumably, the subchapter C rules determining the amount by which earnings and profits are reduced by dividend distributions also determine the amount by which the accumulated earnings and profits of an S corporation are reduced by dividend distributions. IRC § 1371(a)(1), § 312(a)(1), (2), (3).

2. **Adjustments for Corporate Transactions.** Another exception to the general rule is found in Section 1371(c)(2) which provides that the accumulated earnings and profits of an S corporation are to be properly adjusted by corporate transactions subject to subchapter C. Accordingly, the accumulated earnings and profits of an S corporation engaging in corporate divisions or reorganizations would presumably be adjusted in the manner specified in subchapter C. IRC § 312(h), 1371(a)(1), (c)(2).

3. **Adjustments for Investment Tax Credit Recapture.** Another exception to the general rule is found in Section 1371(d)(3) which provides that accumulated earnings and profits are reduced by the amount of investment tax credit recapture borne by the S corporation.
III. ACCUMULATED ADJUSTMENTS ACCOUNT

A. Purposes for Accumulated Adjustments Account. Subchapter S does not exact an immediate toll charge on a C corporation that converts to S status. Consequently, a mechanism was needed to differentiate subchapter C earnings of an S corporation from its subchapter S earnings. The mechanism chosen to implement this goal is the accumulated adjustments account (AAA), which measures undistributed taxable income during the period the S election is in effect. Under the applicable rules, distributions are deemed first attributable to taxable subchapter S earnings (represented by the AAA), and second from accumulated earnings and profits. The AAA also serves a purpose after termination of a corporation's S status because distributions may be treated as nondividends to the extent of the corporation's AAA during the so called "post termination period." IRC § 1371(e)(1).

B. Nature of Accumulated Adjustments Account. The AAA, like the accumulated earnings and profits account, is a corporate level account. As a corporate level account, the AAA records the undistributed taxable earnings of the corporation as a whole and bears no relation to (and is not apportioned to) any particular shareholder. The AAA is adjusted in a manner similar to the manner in which subchapter S stock basis is adjusted. Reg. § 1.1368-2(a)(1). IRC § 1368(e)(1)(A).

C. Computation of AAA. The computation of the AAA balance commences on the first day of the corporation's "S period" (most recent continuous period after 1982 during which the corporation has been an S corporation) and is adjusted only during that period. The AAA is adjusted in a manner similar, not identical, to the manner in which the basis of subchapter S stock is adjusted, with several exceptions including the following:

- No Adjustment for Subchapter C Taxes. AAA is not adjusted for the payment of taxes attributable to subchapter C years. These payments however do reduce stock basis. IRC §§ 1368(e)(1) and 1367(a)(2)(D).

- Adjustments for Certain Shareholder-level Items. Under IRC § 1363(b)(2), certain deductions that would otherwise arise with respect to the operations of an S corporation are not allowed to the corporation (such as the deduction for oil and gas depletion and the charitable contributions deduction).

- Tax Exempt Income and Deductions. Stock basis is increased and decreased, respectively, by tax exempt income and expenses related to the production of tax exempt income, while the AAA is not adjusted.
by these items. IRC § 1368(e)(1)(A).

- **Negative Balance in AAA.** Although the basis of the shareholder's stock may not be reduced below zero, losses can reduce the AAA below zero.

- **Contributions and a Corporation's Sale of Stock.** Stock basis is increased by contributions to capital by a shareholder, but AAA is not increased by such contributions. Further, AAA is not increased by the receipt of the proceeds from the sale of stock by the corporation.

D. **Effect of Distributions on AAA.** Distributions not constituting dividends out of accumulated earnings and profits reduce the AAA (whether or not they exceed stock basis). Reg. § 1.1368-2(a)(3)(iii).

E. **Effect of Redemptions on AAA.** If a redemption of subchapter S stock is treated as a sale or exchange, the AAA is reduced in proportion to the shares of stock redeemed. IRC § 1368(e)(1)(B). A redemption treated as a sale or exchange under IRC § 302(a) or 303(a) adjust AAA, whether negative or positive, at the time of the redemption, not at the end of the corporation's year.

- **Distributions and Redemptions in the Same Year.** In a tax year in which an S corporation makes redemptions (treated as exchanges) and distributions, a corporation adjusts its AAA first for any distributions made during the year and then for redemptions treated as exchanges made during the year.

- **Redemptions Treated as Distributions.** If a redemption is treated as a distribution, the AAA is adjusted in the same manner it would be if the distribution were made. Accordingly, AAA will be disproportionately reduced with respect to a particular shareholder on the redemption.

F. **Effect of Reorganizations on AAA.** If an S corporation acquires the assets of another S corporation in a tax free reorganization, the acquiring corporation succeeds to and merges its AAA with the AAA of the target. Reg. § 1.1368-2(d)(2). If an S corporation with accumulated earnings and profits participates in a divisive reorganization governed by Section 368(a)(1)(D), the AAA of the distributing corporation immediately before the separation is allocated between the distributing and controlled corporations in a manner similar to the manner in which earnings and profits of a distributing corporation are allocated under Section 312(h). Reg. § 1.1368-2(d)(3).
G. Transfer or Issuance of Shares. Because AAA is a corporate level measure of undistributed income that is computed without regard to the particular circumstances of any shareholder, the AAA is not personal to any shareholder and therefore each shareholder owning shares has a proportionate claim on the AAA, irrespective of when or in what manner he acquired his shares.

IV. EFFECTS OF DISTRIBUTIONS TO SHAREHOLDERS

A. Distributions to Which Subchapter S Distribution Rules Apply. Subchapter S (Section 1368) applies to any distribution made by an S corporation with respect to its stock to which Section 301(c) would apply, but for Section 1368. Section 301(c) applies to cash and property distributions, as well as stock redemptions not treated as sales or exchanges under Section 302, redemptions of Section 306 stock under Section 306(a)(2), and distributions of stock under Section 305. In addition to Section 301 distributions, the subchapter S distribution rules under Section 1368 also apply to any other rules of the Code pursuant to which a corporate distribution would be treated as a dividend. Reg. § 1.1368-1(a).

B. Distributions by Corporations with No Accumulated Earnings and Profits.

1. In General. An S corporation having no accumulated earnings and profits at the end of the corporation’s taxable year may distribute cash tax free to a shareholder to the extent of the shareholder’s stock basis. A distribution reduces a shareholder’s basis by the amount of the distribution but does not reduce the shareholder’s basis below zero. A portion of a distribution exceeding the shareholder’s stock basis is treated as gain from the sale or exchange of property. A distribution is tax free only to the extent of the basis of the shareholder’s stock; distributions in excess of the basis of stock are taxable even though the shareholder may have basis in obligations of the corporation to him. IRC §§ 1368(b)(2), 1367(a)(2).

2. Maintaining Stock Basis Share-by-Share. Stock basis must be maintained on a share-by-share basis. Therefore, a shareholder must maintain sufficient records to separately track the separate basis of each share. This will be important so that on a disposition of less than all the shares, the shareholder can determine the amount of gain or loss realized on the disposition. Although the regulations require that a separate basis be maintained in each share, the regulations allow a shareholder to in essence aggregate stock basis for distribution purposes. Reg. § 1.1367-1(c)(3).
3. **Timing of Distributions.** Adjustments to the basis of stock are generally made at the end of the taxable year. Basis is first increased by items of income, is then decreased by items of deduction and loss, and finally is decreased by distributions. Reg. § 1.1368-1(e). Because basis adjustments are made at the end of the year, basis in stock at the time of a distribution has no bearing on whether the distribution will be taxable; rather, it is basis at the end of the year that is important. Consequently, unanticipated losses subsequent to the date of a distribution can convert what would otherwise have been a tax-free distribution to a taxable one.

4. **Transfers of Shares Other Than the End of Year — Elections to Close the Books.** Adjustments to basis are determined as of the close of the taxable year and are generally effective as of that date. However, if a shareholder disposes of stock during the corporation’s year, the adjustments relative to the stock transferred are effective immediately before the transfer. Reg. § 1.1367-1(d)(1).

**Example.** S corporation X has a sole shareholder A, who holds two shares of X’s outstanding common stock. Assume A acquired his shares of stock at the beginning of X’s current taxable year, that A acquired one share for $50 and that A acquired the other share for $150. During the taxable year in question, X realizes $200 in income. Assume that in the middle of the year X distributes $100 and that A sells his high-basis stock to B for $150. No election is made to close the books. Under the per-share, per-day allocation rule of Subchapter S, A would be allocated $100 in income (one-half of the year’s income) for the first half of the year and would be allocated $50 in income for the second half of the year (because his stock ownership would have been reduced by one-half). The first $100 in income would be allocated pro rata among A’s two shares held to the middle of the year, increasing the basis in his low-basis stock to $100 and increasing the basis in his high-basis stock to $200. Thus, on the date of the sale of the high-basis stock to X, A would have had a basis of $200, reduced by one-half of the pre-transfer distribution of $100 to $150. A would therefore realize no gain or loss on the sale. If A had sold his low-basis stock, he would have realized a gain of $100 ($150 purchase price, less the basis of the transferred stock ($50 beginning basis, increased to $100 by income for the date of transfer, less the $50 distribution made relative to those shares, or $50)).

The results in this example can be affected by elections that can be made to close the books of the corporation on a transfer of shares. If no election is made to close the books, A in the example will be unable to ascertain until
the end of the year his basis in the transferred shares because the income or loss for the corporation’s entire year must first be determined in order to determine the allocation of income or loss under the general per-day, per-share allocation rule of Section 1377(a)(1). To the contrary, if an election to close the books is made, the tax items of the corporation can be determined by closing the books of the corporation as of the date of the transfer.

Example. Assume S corporation X has a sole shareholder, A, who has a $50 basis in his stock at the beginning of the year. Assume that precisely at midyear, A transfers all of his stock to B for $100. Prior to the transfer, X recognizes $100 in net profit which it distributes to A. Following A’s sale of stock, X suffers a $200 loss. If A does not file an election to close the corporation’s books, A’s beginning stock basis of $50 will be reduced to $0 by his share of the $100 net loss, he will recognize $100 in gain on the distribution and he will recognize $100 in gain on the sale of his stock. If A’s $50 loss offsets his $200 in gain, his net gain will be $150. To the contrary, if A had elected to close the books of the corporation, his $50 beginning basis would have increased to $150, the tax-free distribution of $100 would have reduced his stock basis to $50 and he would have recognized $50 in gain on his sale of stock. Thus, A would have reported $100 in income from operations and $50 in gain from the sale.

C. Distributions by Corporations with Accumulated Earnings and Profits.

1. In General. A distribution by an S corporation having accumulated earnings and profits is taxed in the following manner: (i) a distribution reduces the AAA and constitutes a nondividend to the extent of the balance of the AAA. The portion of the distribution not exceeding the AAA reduces, and is tax free, to the extent of shareholder’s basis in the stock. To the extent the portion of the distribution not exceeding the AAA exceeds the basis in the shareholder’s stock, the distribution results in gain; (ii) the portion of the distribution exceeding the AAA is treated as a dividend to the extent of the S corporation’s accumulated earnings and profits; and (iii) if there is any portion of the distribution remaining after steps (i) and (ii), the balance of the distribution is tax free to the extent of the shareholder’s stock basis. To the extent this portion of the distribution exceeds the shareholder’s stock basis, the distribution results in gain.

2. Multiple Distributions That Exceed AAA — In General. If distributions for a particular year cumulatively exceed a corporation’s AAA at the end of the year, generally the AAA is apportioned among
the distributions made during the year "in proportion to their relative sizes." IRC § 1368(c). The regulations provide a special rule for allocation of AAA among the components of certain distributions consisting of money and other property. The regulations provide that for distributions that (i) consist of money and other property whose fair market value exceeds its basis, (ii) are made by an S corporation having accumulated earnings and profits, and (iii) exceed the amount of the AAA allocated to the distribution, the amount of AAA allocated to the property is equal to the amount of the AAA allocated to the distribution multiplied by a fraction, the numerator of which is the fair market value of the property and the denominator of which is the amount of the distribution. The remainder of the AAA allocated to the distribution is allocated to the money distributed. Reg. § 1.1368-2(c).

(a) Timing of Distributions. Adjustments to the AAA are generally made at the end of the taxable year. The AAA is generally increased by items of income, is then decreased by items of deduction and loss, and finally is decreased by distributions. Consequently, the balance of the AAA at the time of a distribution has no bearing on whether the distribution will ultimately be taxable; rather it is the balance in the AAA at the end of the year that is important. Consequently, unanticipated losses subsequent to the date of a distribution can convert what would have otherwise been a nondividend distribution out of AAA to a taxable dividend.

The AAA can reflect a negative balance as a result of the pass through of losses. A distribution made when the S corporation has a deficit in its AAA would be treated as a dividend to the extent of earnings and profits. A corporation beginning the year with a deficit in its AAA may have earnings equal to the deficit effectively locked in the S corporation.

3. Tax-Exempt Income and Related Expenses. Tax-exempt income and expenses related to the production of tax-exempt income do not increase or decrease the AAA. This rule may prevent an S corporation with accumulated earnings and profits from distributing tax-exempt income without tax.

Example. S corporation X has $100 of accumulated earnings and profits. During its first taxable year as an S corporation, X's sole source of income and deduction is $110 of tax-exempt
income and $10 of expenses incurred in generating the tax-exempt income. Under Section 1367, stock basis in X increases by the $110 in tax-exempt income and decreases by the $10 expense. However, the $100 in tax-exempt income and the $10 in expense do not increase or decrease the AAA (which at the beginning of the year was $0). Consequently, the distribution of the $100 of tax-exempt income is treated as a taxable dividend because of the existence of earnings and profits.

4. Means of Eliminating Accumulated Earnings and Profits — Election to Treat Distributions as Dividends. In the following circumstances shareholders may desire to treat distributions as dividends: (i) to avoid the corporate level tax on passive investment income and to avoid the termination of the S election (IRC §§ 1362(d)(3), 1375); (ii) the investment income generated by a dividend may be useful if the shareholder has investment interest subject to Section 163(d); (iii) the shareholder may have an expiring net operating loss deduction; or (iv) if the S corporation was a C corporation during the preceding taxable year, a dividend during the first two and a half months of the subchapter S year may avoid the accumulated earnings or personal holding company tax for the subchapter C year.

An S corporation can elect to bypass the AAA and treat distributions during the year as dividends to the extent of accumulated earnings and profits. Under this rule, amounts distributed during the year in excess of accumulated earnings and profits would be treated as tax free recovery of a shareholder’s stock basis, and amounts in excess of basis would be treated as gain. IRC § 1368(e)(3). The AAA bypass election is effective only if all persons who receive distributions during the corporation’s taxable year consent. The AAA bypass election applies to all distributions made during the taxable year.

Example. S corporation X has accumulated earnings and profits at the end of the year of $100 and has an AAA of $200 at the end of the year. X’s sole shareholder has a basis of $200 in his stock at the end of the year. X makes the AAA bypass election for the year. Assume X distributes $150 during the year. The first $100 will be treated as dividend income. The next $50 will be treated as a tax-free reduction of basis.

(a) Alternatives to Cash Distributions. Often times an S corporation desiring to purge its accumulated earnings and
profits does not have sufficient cash to pay the necessary dividend, or rather, the corporation has the cash but needs it for future operations.

- **Deemed Distribution Election.** The regulations allow an S corporation to elect deemed dividend treatment with respect to accumulated earnings and profits. The amount of the deemed dividend is considered as if it were distributed in cash to the shareholders in proportion to their stock ownership and then were immediately recontributed by the shareholders to the corporation, all in the last day of the corporation's taxable year. Reg. § 1.1368-1(f)(3).

- **Distribution of Corporation's Note.** The distribution of a corporation's own note can, in appropriate circumstances, be treated as a dividend in the amount of the principal of the obligation. See PLR 9003042.

D. **Disproportionate Distributions.**

1. **Disproportionate Distributions — Second Class of Stock and Other Concerns.** The single class of stock requirement would appear to preclude disproportionate distributions in the subchapter S context. The keys to determining whether disproportionate distributions are permissible are set forth in the regulations under Section 1361(b)(1)(D). The regulations generally look to "whether all outstanding shares of stock confer identical rights to distributions and liquidation proceeds." This determination is generally based on the "governing provisions" (the charter, bylaws, applicable state law, and "binding" agreements relating to distribution and liquidation proceeds.) Reg. § 1.1361-1(l)(2)(i).

- **Waiver of Distributions.** A shareholder generally has the right under state law to waive a distribution that would otherwise be made to him, meaning that distributions would be made with respect to some shares, but not others. Although this may raise gift tax questions, the mere waiver of a distribution should generally not constitute a second class of stock unless the waiver is part of a binding agreement or is contained in the corporation's governing provisions.

- **Redemption Treated as Distribution.** A redemption of stock treated as a distribution will necessarily be disproportionate.
Because this treatment is mandated by the Code, it arguably should not raise second class of stock concerns unless the distribution is made pursuant to a binding agreement in effect before the specific redemption was contemplated, or the redemption is made pursuant to the corporation's governing provisions.

- **Repayment of Debt.** Repayment of debt classified as some form of an equity investment may constitute a disproportionate distribution made with respect to the equity interest. Assuming the equity were not characterized as a second class of stock, repayments with respect to such an equity interest would not appear to raise second class of stock concerns.

- **Timing of Distributions.** Distributions that differ in timing will not cause an S corporation to have more than one class of stock, provided that the difference in timing does not occur by reason of a "binding agreement" relating to distribution or liquidation proceeds that has as a principal purpose the circumvention of the single class of stock requirement. Reg. § 1.1361-1(l)(2)(v), example 2.

- **Minimum Distribution Provisions.** A common provision now included in a typical shareholder’s agreement will often require that the corporation distribute to the shareholders an amount of cash each year sufficient to allow the shareholders to pay their federal income tax. These minimum distribution provisions can create second class of stock concerns if the shareholders’ relative stock ownership changes during the taxable year. The regulations provide that distributions that, as a result of a change in stock ownership, are to be made on the basis of the shareholders’ varying interests in the S corporation’s income in the current or immediately preceding taxable year will not result in a second class of stock. If distributions are not made within a reasonable time after the close of the taxable year, the distributions may be recharacterized depending upon the facts or circumstances, but will not result in a second class of stock. Reg. § 1.1361-1(l)(2)(iv).

- **Unreasonable Compensation.** If a shareholder receives unreasonable compensation, and if the portion of the unreasonable compensation is treated as a distribution, a disproportionate distribution will have occurred. The regulations appear to adopt the view that unreasonable
compensation may result in a second class of stock, but only if
the compensation agreement was entered into with the principal
purpose of circumventing the single class of stock requirement.
Reg. § 1.1361-1(l)(2)(v), example 3.

- Impact of Below Market Loans. Under Section 7872, the
foregone interest on a below market rate loan from an S
corporation to a shareholder is treated as a deemed distribution
to that shareholder and then as a payment of interest by the
shareholder to the corporation. Such a below market loan will
not cause the corporation to have more than one class of stock
provided that the loan agreement was not entered into with the
principal purpose to circumvent the single class of stock
requirement and, therefore, was not a "governing provision."
COMPENSATION

I. GENERAL

A. General Effects of Cash Compensation. An S corporation may deduct cash compensation paid to an employee, provided the amount is reasonable and constitutes payment for services actually rendered to the corporation. An employee recognizes income upon the receipt of such compensation.

B. General Effects of Noncash Compensation. The tax effects to an S corporation and its employee differ depending on the type of noncash consideration used.

- **Stock.** An employee who receives S corporation stock for services rendered recognizes income equal to the fair market value of the stock and the S corporation generally may deduct a like amount. The S corporation does not, however, recognize gain or loss on a transfer of stock. IRC § 1032. If stock received by an employee is nontransferable or subject to a substantial risk of forfeiture, employee recognition of income and the corporation's deductions are postponed unless the employee makes a Section 83(b) election.

- **Stock Options.** The tax effects of a transfer of stock options by an S corporation to its employee are generally postponed until the employee exercises the options. At the time of exercise, the tax treatment is similar to the tax treatment of a transfer of stock. If the stock options qualify as incentive stock options under IRC § 422A, the realization of income by the employee is generally postponed until the disposition of the stock and no deduction is available to the corporation.

- **Other Property.** An employee recognizes income and an S corporation may claim a deduction in an amount equal to the fair market value of the property transferred to the employee. In addition, the S corporation recognizes gain in an amount equal to the difference between the basis and the fair market value of the transferred property. A loss may be recognized by the corporation on a transfer of property to an employee, provided such employee does not own (directly or indirectly) more than 50% in value of the outstanding stock of the S corporation. IRC § 267(a)(1), (b)(2).

C. Timing Considerations. An S corporation that uses the accrual method of accounting generally claims a deduction for salary when the liability is fixed and the amount can be reasonably determined. An employee that uses the cash method of accounting can, however, postpone the recognition of income
until he actually or constructively receives salary. The ability of the corporation to claim a deduction for salary in one year and for a shareholder-employee to defer the recognition of income to a subsequent year would be advantageous under the pass through system of taxation under subchapter S. Section 267 prohibits this deferral opportunity by effectively requiring an accrual method S corporation to use the cash method with respect to compensation payments made to certain employees, including shareholders. Under Section 267 a deduction cannot be claimed until the salary is includable in the income of the shareholder-employee. Section 267 applies not only to compensation accrued for an employee who "directly" owns stock of an S corporation, but also to compensation accrued for any person who "indirectly" owns any stock and any person "related" (within the meaning of Sections 267(b) or 707(b)(1) to any person who directly or indirectly owns stock.

D. Reasonableness of Compensation. An S corporation can deduct reasonable compensation paid to an employee. The payment of unreasonable compensation will not violate the single class of stock requirement unless it is paid pursuant to an agreement entered into with the principle purpose to circumvent the single class of stock requirement. Reg. § 1.1361-1(i)(2)(v), example 3. If fewer than all shareholders are employees or if compensation of fewer than all shareholder-employees is deemed to be unreasonable, at least a portion of the additional corporate income resulting from a loss of the compensation deduction will be allocated to persons who did not receive compensation payments.

E. Employment Taxes and Wage Withholding. Salary paid an employee by an S corporation is subject to both the FICA and FUTA in addition to wage withholding. Distributions made by an S corporation to a shareholder are exempt from FICA, FUTA and wage withholding liabilities. Accordingly, a shareholder-employee may attempt to characterize the distribution by an S corporation as a distribution made with respect to his stock to avoid these liabilities. The Service has, however, ruled that distributions made to a shareholder-employee will be recharacterized as salary for purposes of the FICA, FUTA and wage withholding liabilities to the extent of the amount of reasonable compensation that would have otherwise been paid to him. Rev. Rul. 74-44, 1974-1 CB 287; Radtke v. U.S., 895F.2d 1196 (CA7 1990); Dunn & Clark, P.A. v. Comm., 853 F. Supp. 365 (D. Id 1994).

F. Self-Employment Taxes. S corporation income passed through to a shareholder-employee under Section 1366(a) is not subject to self-employment tax. Rev. Rul. 59-221, 1959-1 CB 225.
II. COMPARISON OF COMPENSATION PAYMENTS AND STOCK DISTRIBUTIONS

A. Limitations on Discretion as to Method of Disbursement.

1. Recharacterization of Salary Payments as Distributions. A shareholder-employee may prefer salary instead of a distribution with respect to stock. For example, salary may be advantageous if the shareholder-employee is also a creditor of a profitable corporation who has previously claimed losses that have reduced the basis of the corporation's indebtedness to him. Similarly, he may prefer salary if the corporation has accumulated earnings and profits and a deficit balance in its AAA. Salary may also be advantageous if the individual seeks to maximize his benefits under a qualified employee benefit plan. Although salary payments may form the basis for contributions and benefits under a qualified plan, stock distributions and pass throughs of corporate income may not be considered under either a conventional corporate plan or a Keogh plan. Notwithstanding the desirability of the receipt of salary in these instances, the Service may use its general authority under Section 162 to recharacterize the disbursement as a distribution with respect to stock if the amount of salary is unreasonable in relation to the services rendered to the corporation.

2. Recharacterization of Distributions as Salary Payments. A shareholder-employee may prefer a distribution instead of salary. For example, a distribution with respect to stock may be advantageous if the individual seeks to generate capital gain with respect to a disbursement that exceeds stock basis. A distribution may also be advantageous if the individual seeks to avoid the liabilities for employment taxes and wage withholding or if the individual seeks to maximize opportunities under the passive activity loss rules. The Service has ruled that a distribution will be recharacterized as salary for purposes of employment taxes and wage withholding to the extent of the reasonable compensation that would otherwise have been paid to such individual for services rendered to the corporation. Rev. Rul. 74-44, 1974-1 CB 287. Although under compensated services are clearly vulnerable to liabilities for employment taxes and wage withholding, it is not apparent whether the disbursement will be treated as salary for all purposes. See Temp. Reg. § 1.469-2T(c)(4)(ii) (under compensated services with respect to passive activity characterized as passive activity gross income and not compensation for personal services).
III. FRINGE BENEFITS AND QUALIFIED PLANS

A. Fringe Benefits. An S corporation is treated as a partnership and any "two percent shareholder" is treated as a partner of such partnership. IRC § 1372(a). The impact of the treatment of a two percent shareholder as a partner of a partnership is that the payment of fringe benefits to such a person is to be treated like partnership guaranteed payments under Section 707(c).

- **Treatment of Guaranteed Payments Generally.** The cost or value of a fringe benefit paid to or on behalf of a partner that are treated as guaranteed payments is includable in the income of the partner under Section 61. Because the recipient partner is treated as self-employed and not as an "employee" with respect to his distributive share of partnership income, the recipient-partner cannot exclude from income the cost or value of the fringe benefits pursuant to those provisions of the Code which provide exclusions from income in the case of "employees," such as Sections 79 (group-term life), 104 (compensation for injuries or sickness), 105 (accident and health insurance), 106 (employer contributions to accident and health plans), and 119 (meals or lodging). However, the recipient-partner can exclude from income the cost or value of fringe benefits pursuant to those provisions of the Code that provide exclusions to self-employed persons, such as Sections 101(b)(3)(B) (death benefits), 120 (group legal services), 127 (educational assistance program), and 129 (dependent care assistance).

- **Two Percent Shareholders.** Treatment of fringe benefits payable to or on behalf of a two percent shareholder of an S corporation as guaranteed payments results in treatment similar to that described above in the context of a partner.

*Example.* S corporation X pays premiums in the amount of $100 for accident and health insurance on behalf of A, a two-percent shareholder. Because A is not treated as an employee with respect to such premiums, A is not entitled to the exclusion under Section 106 and, therefore, must recognize $100 of income. Because, however, A is treated as a self-employed individual, A may deduct 25% of the cost of such premiums pursuant to Section 162(l), assuming that all the requirements relating thereto are satisfied. Fringe benefits not excludible from income by a two percent shareholder are treated as "wages" for wage withholding purposes. Ann. 92-16.
• **Treatment of Other S Corporation Employees.** An employee who is not a two-percent shareholder qualifies for the statutory exclusions available to employees generally.

• **Treatment by S Corporation.** Guaranteed payments are deductible by a partnership to the extent they are not required to be capitalized. IRC § 707(c). Accordingly, an S corporation can deduct the cost of fringe benefits payable to or on behalf of two-percent shareholders as well as other employees, assuming that all the relevant requirements are satisfied.

• **Definition of Two-Percent Shareholder.** Two-percent shareholder includes any person who on any day during the taxable year of the S corporation owns or is deemed to own (under Section 318) more than two percent of either the outstanding stock of the corporation or the total combined voting power of all stock of the corporation. IRC § 1372(b).

• **Definition of Employee Fringe Benefits.** The term "employee fringe benefits" includes (i) group term life insurance benefits; (ii) death benefits; (iii) accident and health plan benefits; and (iv) certain meals and lodging. IRC § 1372.

B. **Qualified Employee Benefit Plans — General.** The rules governing a qualified employee benefit plan maintained by an S corporation are substantially similar to those applicable to a plan sponsored by a C corporation. There are at least two important distinctions, however:

• **Plan Design.** Generally, assets of a qualified plan must be held by a trust. A qualified employee benefit plan trust is not a permissible shareholder of an S corporation and therefore may not hold stock in an S corporation. Accordingly, plans designed to invest in employer stock generally may not be maintained by an S corporation.

• **Plan Loans.** Generally, employee benefit plans may make loans to participants. IRC § 4975(d)(1). Unless an exemption is obtained from the Department of Labor, a plan loan to an "owner employee" constitutes a prohibited transaction within the meaning of Section 4975(a) subject to an excise tax equal to as much as 100% of the amount loaned. An owner-employee is defined to include any employee or officer of an S corporation who owns, or is deemed to own pursuant to the attribution rules of Section 318, more than five percent of the outstanding stock of the corporation.
C. **Individual Retirement Accounts.** Salary received from an S corporation is considered compensation that may be contributed to an individual retirement account. Corporate income that passes through to a shareholder-employee under Section 1366(a) is not considered compensation for this purpose. See Rev. Rul. 59-221, 1959-1 CB 225.

IV. **EXECUTIVE COMPENSATION**

A. **Stock Programs**

1. *Nonvoting Stock.* Issuance of nonvoting stock by an S corporation to its key employees is often desirable because the key employee acquires a proprietary interest in the S corporation without the existing shareholder sacrificing voting control. Although the issuance of nonvoting stock by an S corporation does not violate the single class of stock requirement, other S corporation issues must be addressed. First, a nonvoting shareholder is treated as a shareholder for purposes of the thirty-five shareholder limitation for an S corporation. Second, the shareholder cannot be a non-resident alien. Finally, the impact of the issuance of nonvoting stock to a key employee on the treatment of fringe benefits paid or offered by the S corporation to the employee must be addressed. If the key employee ends up owning more than two percent of the outstanding stock of the company (including nonvoting stock) Section 72 will operate to characterize the S corporation as a partnership for purposes of provisions of the Code that relate to employee fringe benefits. See preceding portion of this outline dealing with Fringe Benefits.

2. *Restricted Stock Plans.* Under a restricted stock plan a corporation will issue stock to a key employee either without cost or for a nominal price. The key employee’s right to ownership in the stock is made subject to various restrictions such as continued employment for a designated term of years. There is also typically a vesting schedule. The key employee will generally include in income an amount equal to the excess of the fair market value of the stock over the amount he paid for the stock in the first taxable year in which the shares are either transferable or not subject to a substantial risk forfeiture. The key employee may elect under Section 83(b) however to recognize income in the year in which he receives the stock. IRC § 83(a), (b). Restricted stock issued by an S corporation is not considered outstanding for purposes of subchapter S unless a Section 83(b) election is made. Accordingly, in the absence of a Section 83(b) election, ownership of restricted stock differs in at least two respects
from ownership of conventional stock of an S corporation. First, because restricted stock is not treated as outstanding (in the absence of a Section 83(b) election) any distributions made by the S corporation to the key employee-shareholder with respect to the restricted stock constitutes taxable compensation to the key employee. Consequently, a key employee who owns restricted stock cannot treat any amounts distributed with respect to the stock as a tax-free return of basis (a distribution of AAA). Reg. § 1.83-2(a). Second, an owner of restricted stock is not considered a shareholder for purposes of allocating items of income, loss, and deduction of the S corporation.

B. Options and Convertible Debenture Plans.

1. Nonstatutory Stock Option Plans. A nonstatutory stock option plan typically grants a key employee the right to purchase stock at a price below market value at the time of the grant of the option. The most significant concern in connection with the issuance of stock options by an S corporation is whether they violate the single class of stock requirement. Generally, the issuance of the stock option will violate the single class of stock requirement if, taking into account all the facts and circumstances, two conditions are satisfied. First, the option must be substantially certain to be exercised by the holder or a potential transferee. Second, the option must have a strike price substantially below the fair market value of the underlying stock on the date that the option is either issued, transferred to a person who is not an eligible S corporation shareholder, or "materially modified." Reg. § 1.1361-1(l)(4)(iii)(A). A safe harbor provides that an option will not be treated as having a strike price substantially below the fair market value of the stock if the strike price is at least 90% of the fair market value of the underlying stock on the date the option is issued, transferred to a person who is not an eligible shareholder, or materially modified. Reg. § 1.1361-1(l)(4)(iii)(C).

Another important exception provides that the issuance of an option to an employee or an independent contractor in connection with the performance of services (and which is not excessive by reference to the services performed) will not violate the single class of stock requirement if the option is "nontransferable" and if the option lacks a "readily ascertainable fair market value" at the time the option is issued. Reg. § 1.1361-1(l)(4)(ii)(B)(2). To ensure that an option is "nontransferable," the employee or independent contractor should be precluded from selling, assigning, or pledging the option.

2. Incentive Stock Option Plans. The principal difference between an
C. **Nonstock Incentive Programs.**

1. **Annual Bonus Plans.** An annual bonus plan is a short term compensation technique by which an executive receives a portion of a corporation's profits. The Service has ruled privately that participation in such a plan does not cause the executive to be considered a shareholder of the corporation. (See PLR's 8506114 and 8828029.) Further, the Service has ruled privately that a bonus plan that pays awards determined by reference to the amount of dividends paid on actual shares of stock does not violate the single class of stock requirement, provided that: (i) the bonus plan is intended merely as a measurement device designed to determine the amount of additional compensation payable to participants; (ii) participants' rights under the plan are nonassignable and nontransferable; and (iii) participation does not extend beyond the term of employment. See PLRs 8838049, 8937034 and 8907032.

2. **Performance Unit Plans.** A performance unit plan is similar to an annual bonus plan except that awards are based on attainment of corporate objectives over a period of years. Generally, a performance unit plan provides for payments to participants to the extent that the average annual growth of the corporation's earnings per share exceeds a specified objective. Although the Service has not ruled on the viability of the performance unit plan sponsored by an S corporation, such a plan should not jeopardize a corporation's S status. Participants typically obtain none of the rights associated with stock ownership (vote, right to distributions and proceeds in liquidation). Further, the single purpose of such a plan appears to be its use as a measurement device to determine the amount of additional
compensation paid to participating executives. See PLR 8838049.

3. **Stock Appreciation Rights.** A stock appreciation right (SAR) permits an executive to receive cash equal to the appreciation in value of a share of corporate stock occurring between the date of grant and the date of exercise. The Service has ruled that because a SAR recipient cannot vote or share in corporate assets upon liquidation, the issuance of a SAR by an S corporation does not violate the single class of stock requirement. See PLRs 9817009 and 8828029.

4. **Phantom Stock Plans.** Benefits under a phantom stock plan are determined not by the ownership of actual shares of the corporate stock but by units the value of which are determined by reference to shares of stock. Typically, the value of a unit is comprised of two elements. One is the value of dividends paid or accrued on the shares of outstanding common stock. The second element is the appreciation in the value of a share of stock that occurs between the date of grant and the settlement date. The Service has sanctioned the adoption of a phantom stock plan by an S corporation. See GCM 39750.

D. **Other Executive Arrangements.**

1. **Below-Market Loans.** A corporation may loan funds to an executive either at no interest or a low rate of interest. Only if such a loan is made pursuant to an agreement that is entered into with the principle purpose to circumvent the single class of stock requirement will such an arrangement jeopardize a corporation’s S status. See Reg. § 1.1361-1(l)(2)(v), example 5.

2. **Rabbi Trusts.** Under such an arrangement, an irrevocable trust is established for the benefit of the executive and funded with assets that will pay benefits at a future date. Generally, the use of a rabbi trust by an S corporation does not present a problem. If the trust is funded with stock of the S corporation, however, termination of the S election may result. Although the trust is created for the benefit of the executive, it is characterized as a grantor trust owned by the corporation. Characterization of the corporation as the deemed owner of the trust and the trust assets may violate the restriction against ownership of S corporation stock by a corporation.

3. **Split Dollar Insurance.** Split dollar insurance is a method of purchasing permanent life insurance in which two parties agree to share the policy benefits (the cash value and the death benefit). The classic split dollar plan entails payment by the employer (the S
corporation) of the portion of annual premiums equal to the annual increase in the insurance policy’s cash surrender value and payment by the employee of the balance of the annual premium. In the event of the death of an employee, the employer (the S corporation) generally receives from the insurance proceeds an amount equal to the cash surrender value (or the aggregate premiums paid if greater). The beneficiary of the policy receives the balance of the insurance proceeds.

The Service has ruled privately that a split dollar insurance plan between an S corporation and a shareholder-employee does not violate the single class of stock requirement. In one ruling, the Service concluded that the payment by the employer of the policy premiums constituted a "fringe benefit" to the employee and was not a vehicle for the circumvention of the single class of stock requirement. See PLR 9248019. In a second ruling, the Service concluded that because the shareholder-employee of the corporation (or an irrevocable trust created by the shareholder-employee) was required to reimburse the corporation for the "economic benefit" conferred upon the shareholder-employee, the split dollar plan did not alter the rights to distribution and liquidation proceeds and, hence, did not violate the single class of stock requirement. See PLR 9318007. The Service has also ruled that a split dollar insurance plan between an S corporation and its nonemployee-shareholders does not violate the single class of stock requirement if such shareholders (or the irrevocable trust created by the shareholders) are required to reimburse the S corporation for the "economic benefit" conferred upon the shareholders. See PLRs 9331009 and 9309046.

4. **Examples of Split-Dollar Arrangements.**

(a) **Contributory Split-Dollar Plan.**

- Insured (usually an employee) pay the portion of the premium that equals the annual economic benefit of the coverage on the employee’s life.

- Benefit is usually the lesser of the P.S. 58 cost or the insurer’s current published one-year term rates available to all standard risks.

- S corporation pays the balance of the premium.

(b) **Noncontributory Split-Dollar Plan (Employer-Pay-All).**
Insured does not pay the cost of the annual economic benefit (the S corporation pays it).

Although the insured is taxed on the benefit, the S corporation cannot deduct the amount that is taxed to the insured.

If insured is a shareholder (but not an employee), deemed distribution of annual economic benefit to shareholder may create second class of stock and terminate corporation's S election.

Result is a double tax on a portion of the insurance premium (see example below).

Noncontributory split-dollar plans generally are not advisable for S corporations and their shareholder/employees.

**Example of Noncontributory Split-Dollar Plan.** Assume S corporation has three equal shareholders: A, B, and C. S corporation has $2,100 of taxable income and pays a $2,100 premium to insure C under a noncontributory split-dollar plan. Assume the cost of the annual economic benefit to C for year one is $360.

The tax result is not favorable. Each of A, B, and C will be taxed on $700 of taxable income (of course, none of the premium payment is deductible by S corporation). In addition, C will be taxed on the $360 annual economic benefit (the $360 benefit to C is not deductible by S corporation).

Consequently, the shareholders are taxed on a total of $2,460. The $360 is taxed twice.

**Example of Contributory Split-Dollar Plan.** Same facts as above except that the split-dollar plan is a contributory plan and S corporation pays C a $360 bonus to cover his portion of the premium obligation. C pays his $360 share of the premium.

S corporation may deduct the $360 bonus payment. Consequently, S corporation has $1,740 of taxable income ($2,100-$360). Each of A, B, and C will be taxed on $580 of taxable income (one-third of $1740). C will also be taxed on the $360 bonus.

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1 Both examples are from S Corporations and Life Insurance, Section of Real Property, Probate and Trust Law. (1992)
Consequently, the total amount taxed is $2,100. The employee’s share of the premium ($360) is taxed only once. Same result if C contributes his $360 annual benefit cost to S corporation.

(c) **Effect of Premium Payments Under Split-Dollar Plan on Stock Basis.**

- S corporation stock basis should be decreased by the excess of the premium amount paid for the year over the increase in the cash value for the same year.

(d) **Effect of Premium Payments Under Split-Dollar Plan on S Corporation’s Accumulated Adjustments Account (AAA).**

- Premium payments have no effect on an S corporation’s AAA.

- Premium payments that decrease stock basis will create a difference between an S corporation’s AAA and its shareholders’ stock basis.

(e) **Receipt of Proceeds by S Corporation.**

- S corporation entitled to receive its cumulative net premium outlay with a noncontributory plan, or its total premiums paid minus the employee contributions with a contributory plan.

- Receipt of proceeds are tax exempt to S corporation and increase the stock basis of S corporation’s shareholders by an amount equal to the excess of S corporation’s share of the proceeds over S corporation’s basis in the policy.

- Receipt of proceeds has no effect on S corporation’s AAA.
INTRODUCTION

In preparing or reviewing a shareholder buy/sell agreement among an S corporation and its shareholders, a number of matters that are peculiar to S corporations must be examined.

II. ELECTING AND PRESERVING S CORPORATION STATUS

A. Electing S Corporation Status. Unanimous consent of shareholders is required for a corporation to elect S status. Shareholders expecting their corporation to convert to S status at some future time should consider addressing the possibility of an S election in the shareholders’ agreement. For example, the shareholders could agree to convert the corporation to S status upon the approval of a specified percentage of the outstanding shares. As part of the agreement, each shareholder could appoint an attorney-in-fact to consent, upon the approval of a specified percentage of the shareholders, to the corporation’s election to be an S corporation. This technique avoids two potential problems. First, a minority shareholder is unable to withhold his consent in an effort to thwart the desire of a corporation and its remaining shareholders to convert the corporation to S status. Second, if a shareholder sells all of his stock and the corporation desires to make an S election retroactive to the beginning of its taxable year, the designated attorney-in-fact may consent to the S election on behalf of the former shareholder.

B. Preserving S Corporation Status. A shareholders agreement can be drafted to help prevent termination of a corporation’s S status. An S election may be revoked or a corporation or its shareholders may act (or fail to act) in such a manner that the corporation no longer qualifies as an S corporation. To avoid a deliberate or inadvertent termination of a corporation’s S status, an agreement among the shareholders and the corporation should contain appropriate safeguards and conditions to ensure that the corporation continues to qualify for S corporation status except in those circumstances in which the parties agree that the corporation’s status should be terminated.

1. Transfers to Permissible Shareholders. A transfer of S corporation stock to an ineligible shareholder immediately terminates the corporation’s S status, unless the Service determines that the termination is inadvertent. IRC § 1361(b)(1)(B), (C); IRC § 1362(d)(2), (f). To safeguard against the loss of S status resulting from a transfer of stock to an impermissible shareholder, an agreement
should limit impermissible transfers of shares during life and at death.

2. **Limit on Number of Shareholders.** No more than thirty-five shareholders may own stock of an S corporation. If at any time a corporation has more than thirty-five shareholders, its S status terminates immediately, unless the Service determines the termination to be inadvertent. IRC §1362(d)(2), (f). To safeguard against such a transfer, the shareholders and the corporation should agree on some procedure to monitor or restrict stock transfers that cause the corporation to exceed this ceiling on the number of shareholders.

3. **Shares Held by QSST.** If a qualified subchapter S trust (QSST) owns shares of an S corporation, the current income beneficiary of the trust must file a proper QSST election to qualify the trust as an eligible shareholder. IRC §1361(b)(1)(B), (c)(2)(A)(i), (d)(1). If a QSST election is not made, the trust is an ineligible shareholder and the corporation’s status terminates, unless the Service determines the termination to be inadvertent. Because failure to file a proper QSST election causes a termination of the corporation’s S status, an agreement among the shareholders and the corporation should maximize the likelihood that a trust’s current income beneficiary will file a proper QSST election. For example, the parties could condition a transfer of S corporation stock to a trust that qualifies as a QSST on the current income beneficiary’s agreement to make a proper and timely QSST election.

- A QSST’s income beneficiary may revoke a QSST election with the consent of the Service. An agreement should protect against a current income beneficiary’s attempted revocation of a QSST election. For example, such an action could trigger an automatic purchase of the trust’s shares at a nominal price.

4. **Affiliated Group Limitation.** A corporation cannot qualify as an S corporation if it is a member of an affiliated group. IRC §1361(b)(2)(A). A corporation is a member of an affiliated group if it owns 80% or more of the outstanding shares of another corporation. To prevent a corporation from terminating its S status, an agreement among the corporation and its shareholders could absolutely prohibit the corporation from becoming a member of an affiliated group and terminating its S status, unless a certain percentage of its shareholders consent.
III. TERMINATING S CORPORATION STATUS

A. Revoking S Corporation Status. An S corporation may revoke its S election if shareholders owning more than one-half of the corporation’s outstanding shares (including nonvoting stock) consent to the revocation. Although the Code requires majority approval by the shareholders to revoke, the corporation and the shareholders may desire to increase or decrease this percentage by agreement. For example, an agreement could provide that if shareholders holding a specified percentage (1/3, 2/3, all) of a corporation’s outstanding shares agree to terminate its S status, all shareholders shall consent to revocation of its S status. For example, a minority shareholder may desire to increase the percentage needed to revoke an S election to prevent a majority shareholder from arbitrarily revoking the election and adversely affecting the minority shareholder’s investment in the corporation.

B. Terminating S Corporation Status. A corporation loses its S status if: (i) it properly revokes its S election; (ii) it ceases to be a small business corporation as defined in Section 1361(b); or (iii) it has accumulated earnings and profits and derives more than 25% of its gross receipts from passive investment income for three consecutive tax years. IRC § 1362(d). The Service may waive inadvertent termination of a corporation’s S status if termination is caused by either (ii) or (iii) above. In the agreement, the shareholders and the corporation should consider specifying the conditions under which the corporation will request the Service to waive an inadvertent termination of its S status and thereby reinstate its S election. For example, an agreement could require a corporation to file a request for waiver of an inadvertent termination and require all the shareholders and the corporation to agree to the adjustments required by the Service upon the approval of shareholders holding a specified percentage of the outstanding shares.

IV. ALLOCATING TAX ITEMS

A. Allocation Method — Termination of S Corporation Status. If a corporation’s S election terminates, its taxable year divides into two taxable years, a short S year and a short C year. A corporation’s items of income, loss, deduction and credit are generally allocated between the S short year and the C short year on a daily pro rata basis. Instead of a pro rata, daily allocation between the S short year and the C short year, a corporation may elect (with the consent of its shareholders) to close its books as of the last day of the S short year and allocate all tax items realized during the taxable year between the S short year and the C short year on the basis of when the tax items were actually incurred or realized. To close a corporation’s books as of the last day of the S short year, the following persons must consent to
the election: (i) all shareholders of the corporation at any time during the S
short year and (ii) all shareholders of the corporation on the first day of the C
short year. IRC § 1362(e)(1)(B). Accordingly, the shareholders of the
corporation may wish to agree in advance that in the event the corporation’s
S status terminates, the corporation shall elect, and each shareholder shall
consent to, an interim closing of the corporation’s books.

B. Allocation Method — Termination of Shareholder’s Interest in S Corporation.
If a shareholder terminates his interest in an S corporation, the S corporation
may, with appropriate shareholder consent, elect to close its books on the
date of the termination of the shareholder’s interests for purposes of
allocating items of income, loss, deduction or credit. If an S corporation
elects to close the books, the S corporation’s items of income, loss, deduction
or credit for the taxable year in which the shareholder’s interests in the
corporation terminates are allocated as if the S corporation’s taxable year
consisted of two separate taxable years. The first year ends on the date the
shareholder terminates his interest in the S corporation, and the second year
commences the day after the date of termination.

The election requires the consent of all persons who are shareholders at any
time during the taxable year. Because an election to close the books and the
resulting allocation of tax items may benefit some shareholders at the expense
of others and any one shareholder can prevent the election, the parties should
consider including a provision in their agreement to deal with the issue of
whether the corporation will make an election under Section 1377(a)(2) in the
event a shareholder terminates his interest in the S corporation. IRC §
1377(a)(2).

V. DISTRIBUTIONS TO SHAREHOLDERS

A. Amount and Timing of Distributions. S corporation shareholders must report
and pay income tax on their allocable share of the S corporation’s taxable
income regardless of whether the corporation distributes cash to assist them
in paying the income tax. Shareholders who are unable to dictate or
influence an S corporation’s dividend policy (e.g., minority shareholders or
persons holding nonvoting shares) are vulnerable to the extent the controlling
shareholders can fund their income tax obligation from sources other than the
S corporation. The agreement should consider addressing the issue of
distributions to shareholders to assist them in satisfying their income tax
liability with respect to the S corporation’s income. At a minimum, an
agreement should require a corporation to make distributions of cash to its
shareholders each taxable year in an amount that is not less than the federal
and state income taxes payable by the shareholders because of the income of

- 29 -
the corporation which is taxable to them. The parties should also consider requiring the corporation to make quarterly distributions so as to permit the shareholders to make the necessary estimated tax payments.

B. Distributions of Appreciated Property. The gain recognized by an S corporation on a distribution of appreciated property to its shareholders generally passes through and is taxed to the shareholders. Consequently, each shareholder must include his allocable share of the gain recognized on the distribution of the property regardless of the extent to which he received the distribution of the property. Noncontrolling shareholders who are unable to prevent such an occurrence may desire to include a provision in the shareholder's agreement that either prohibits distributions of appreciated property or conditions such a distribution on the approval of shareholders, both voting and nonvoting, holding a specified percentage of the corporation's outstanding shares.

C. Distributions — Election To Treat as Taxable Dividends. The election to bypass an S corporation's AAA and to treat the distribution as if made from accumulated earnings and profits must have the consent of all shareholders who receive distributions during the corporation's taxable year. Shareholders of an S corporation may prefer to receive taxable, rather than tax-free dividend distributions, if, for example, they desire to eliminate the S corporation's accumulated earnings and profits account and avoid corporate level tax on passive investment income or termination of the corporation's S status. Because any one shareholder who receives a distribution during the corporation's taxable year can withhold consent and prevent the bypass election, the parties should consider including a provision in their agreement to cover the decision to make a bypass election under Section 1368(e)(3).

VI. BUY-SELL PROCEDURES

A. Cross-Purchase Agreement.

1. Seller's Perspective: relatively straightforward.

   • Gain or loss computed by subtracting stock's adjusted basis from sales price.

   • Gain is generally capital gain.

   • If seller is a deceased shareholder's estate, no gain or loss is recognized if sale price is equal to stock's stepped-up basis obtained upon death.
**Example A:** A, B, and C are equal shareholders in Delta, a calendar-year S corporation. Each shareholder initially invested $1,000 for his stock when the corporation was formed on January 1, 1991. During 1991, Delta has net taxable income of $1,200 and distributes $200 to each shareholder on December 31, 1991. On January 1, 1992, A sells all of his stock pursuant to the terms of a cross-purchase agreement to B and C for $2,200. A’s gain is computed as follows:

<table>
<thead>
<tr>
<th>Amount realized</th>
<th>$2,200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Adjusted basis</td>
<td></td>
</tr>
<tr>
<td>Initial basis</td>
<td>$1,000</td>
</tr>
<tr>
<td>Share of 1991 income</td>
<td>400</td>
</tr>
<tr>
<td>1991 distribution</td>
<td>(200)</td>
</tr>
<tr>
<td>Gain on sale of shares</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

2. **Buyer’s Perspective:**
   - Major advantage is that buyer obtains cost basis in purchased stock.
   - (a) losses generally deductible to extent of stock basis
   - (b) assuming no accumulated earnings and profits, distributions to shareholders are tax-free to extent of stock basis.
   - Cross purchase does not affect the S corporation’s accumulated adjustments account (AAA).

B. **Redemption Agreement.**

1. **Seller’s Perspective.**
   - If S corporation has no accumulated earnings and profits, seller does not care whether distribution in redemption qualifies as a sale or a dividend. In both cases, amount received is treated as a return of basis (to the extent of basis) and the balance as gain from a sale.

**Example B:** A and B are equal shareholders in a calendar-year S corporation. A’s stock basis for his stock on July 15, 1991 is $1,000. On that date, the corporation, pursuant to a redemption agreement, redeems all of A’s stock for $2,000. If the transaction is treated as a redemption qualifying for sale or exchange treatment (and not dividend treatment), A’s gain is computed as follows:
Amount realized: $2,000
less: adjusted tax basis 1,000

gain $1,000

The gain is characterized as one arising from the sale or exchange of stock, which results in capital gain treatment.

**Example C:** Assume the same facts as in Example (B) above, except that the payment to A is treated as a dividend. If the S corporation has no accumulated earnings and profits, the $2,000 distribution is characterized as $1,000 of return of stock basis and $1,000 as capital gain.

- If S corporation has accumulated earnings and profits, tax considerations become more complex.
- if redemption is not a sale or exchange under Section 302(a), ordinary income rather than capital gain may result.
- if redemption is not a sale or exchange under Section 302(a), no right to offset stock basis against amount received.

2. **Corporation's Perspective (and Other Shareholders).**

- Use of redemption agreement, rather than cross-purchase, creates no tax saving.
- Timing disadvantage in using a redemption agreement:
  - When S corporation redeems, the other shareholders do not obtain stock basis increase. If future income used to pay-off note to redeeming shareholder, however, basis increases as income earned. Consequently, resulting stock basis to other shareholders will end up being the same as stock basis in a cross-purchase agreement.

- The S corporation's accumulated earnings and profits are reduced in a redemption. Redemption also reduces AAA, however.

3. **Special Problems Involving Redemption Upon Death.**

- If S corporation has accumulated earnings and profits, then make sure that redemption of decedent's stock qualifies for sale treatment rather than dividend treatment.
If redemption agreement funded by life insurance proceeds - be careful.

**Example D:** A and B each own 50 percent of the stock of Inc., a calendar-year S corporation. Each shareholder of the corporation has entered into a buy-sell agreement that provides, upon the death of a shareholder, that the corporation will purchase the stock from his estate for an amount equal to the life insurance proceeds received by the corporation. The corporation purchases a $100,000 life insurance policy on each shareholder's life. Assume that each shareholder's stock basis is zero at the date of A's death, upon which, his estate receives a stock basis equal to fair market value of $100,000. Thereafter, when the insurance proceeds have been paid to the corporation, they are allocated pro rata to each shareholder -- resulting in an additional $50,000 basis increase for A's estate. Upon redemption of A's stock, his estate is entitled to receive only the $100,000 life insurance proceeds. There will be a $50,000 capital loss.

- capital loss to estate is probably wasted.
- other shareholders lose $50,000 of stock basis.
- plan for this in buy-sell agreement.

C. **Tax Effects of Life Insurance.**

1. **Premium Payments.**

- When an S corporation uses taxable income to pay nondeductible insurance premiums, the S corporation's shareholders will pay income tax on the taxable income used to pay the premiums.

- Shareholders may have to rely on other cash sources to pay this income tax liability if the S corporation does not have sufficient cash reserves after payment of the premiums.

(a) **Effect of Premium Payments on Stock Basis.**

- S corporation stock basis is decreased by corporate expenses that are not deductible and are not properly chargeable to capital account.

- Nondeductible term insurance premiums reduce S
corporation stock basis dollar for dollar.

- For premiums paid on cash value policies, S corporation stock basis should be decreased by the excess of the premium amount paid for the year over the increase in the cash value for the same year.

(b) Consequences of Decreases in Stock Basis. The decrease in S corporation stock basis caused by the premium payments will affect three items of potential significance to the S corporation’s shareholders.

- Shareholders can only deduct corporate losses to the extent of stock basis.

- Distributions that exceed stock basis are taxable to the extent of the excess, even though distributions are from the accumulated adjustments account.

- Amount of stock basis will affect the amount of gain or loss recognized by the shareholder if he sells or exchanges his stock in a taxable transaction.

(c) Effect of Premium Payments on S Corporation’s Accumulated Adjustments Account (AAA).

- Premium payments have no effect on an S corporation’s AAA.

- Premium payments that decrease stock basis will create a difference between an S corporation’s AAA and its shareholders’ stock basis.

- Possibility that some S corporation income could be taxed twice under certain circumstances.

Example. Assume S corporation has one shareholder with an initial stock basis of $1000. S corporation has taxable income of $10,000 in each of its first three years. S corporation pays a $3000 annual insurance premium. S corporation distributes $5000 per
year to its shareholder. The remaining $2000 is retained by the S corporation for its operations.

The cash value increase in years 1, 2, and 3 are $1200, $1900, and $3000, respectively.

The shareholder’s stock basis and S corporation’s AAA are computed as follows:

<table>
<thead>
<tr>
<th>Year 1:</th>
<th>Stock Basis</th>
<th>Accumulated Adjustments Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ 1,000</td>
<td>0</td>
</tr>
<tr>
<td>Increase for taxable income</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Decrease for insurance premium expense</td>
<td>(1,800)</td>
<td>N/A</td>
</tr>
<tr>
<td>Decrease for distributions</td>
<td>(5,000)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>$ 4,200</td>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year 2:</th>
<th>Stock Basis</th>
<th>Accumulated Adjustments Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ 4,200</td>
<td>5,000</td>
</tr>
<tr>
<td>Increase for taxable income</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Decrease for insurance premium expense</td>
<td>(1,100)</td>
<td>N/A</td>
</tr>
<tr>
<td>Decrease for distributions</td>
<td>(5,000)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>$ 8,100</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year 3:</th>
<th>Stock Basis</th>
<th>Accumulated Adjustments Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ 8,100</td>
<td>10,000</td>
</tr>
<tr>
<td>Increase for taxable income</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Decrease for insurance premium expense</td>
<td>(0)</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Accumulated Adjustments

<table>
<thead>
<tr>
<th>Stock Basis</th>
<th>Accumulated Adjustments Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>(5,000)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>$13,100</td>
</tr>
</tbody>
</table>

- Tax results to the shareholder:
  
  $30,000 of taxable income ($10,000 per year);

  $1,900 of potential capital gain if company distributes all of its AAA of $15,000

  A double tax on $1,900.

- This result would have been avoided if the shareholder had at least another $1,900 of original stock basis. It can also be avoided if S corporation does not distribute more than $13,100.

- Double taxation will not always result when an S corporation owns life insurance. Double taxation can result, however, because of stock basis or the amount of distributions.

2. Receipt by S Corporation of Death Proceeds.

- Insurance proceeds paid to an S corporation are generally tax exempt. Exceptions exist, however, if the policy is subject to the transfer for value rules.

  (a) Effect of Receipt of Death Proceeds by S Corporation on Stock Basis.

  - Insurance death benefits that are tax exempt to the S corporation increase the stock basis of the S corporation’s shareholders.

  (b) Effect of Receipt of Death Proceeds by S Corporation on AAA.

  - Receipt of death proceeds has no effect on an S corporation’s AAA.
LIMITATIONS ON PASS-THROUGH LOSSES

I. INTRODUCTION. An S corporation’s realization of losses does not immediately translate into losses that a shareholder may use to offset income. The shareholder’s use of such losses is subject to a number of limitations. These limitations include (i) the basis limitation that permits a shareholder to deduct losses only to the extent of the shareholder’s basis in his stock and in the indebtedness of the S corporation to him; (ii) the at risk limitations; (iii) the passive loss limitation; and (iv) the investment interest limitation.

II. BASIS LIMITATION ON PASS THROUGH OF S CORPORATION LOSSES.

A. In General. A shareholder’s basis in his stock and in the indebtedness of the S corporation to him is important because losses realized by an S corporation during the year pass through to the shareholder only to the extent of the shareholder’s collective amount of basis in his stock and in the corporation’s indebtedness to him.

B. Original Basis. The general principles applied to determine the original basis in the stock of a C corporation should be applied to determine the original basis in a shareholder’s stock in an S corporation. IRC Section 1371(a)(1).

1. Stock Received by Gift or Upon Death. The donee’s basis in gifted stock is generally equal to the basis of the stock in the hands of the donor. IRC § 1015(a). The basis of gifted stock in the hands of the donee is increased by the amount of the gift tax attributable to the appreciation of the property at the time of the gift. IRC § 1015(d)(6). In the case of death, stock in an S corporation has a basis equal to its fair market value on the date of the decedent’s death, or, if the alternate valuation date under Section 2032 is selected, on the alternate valuation date. IRC § 1014(a), 2032(a).

2. Converted C Corporations. The beginning basis in a shareholder’s shares in a corporation that converts from subchapter C status to subchapter S status is the shareholder’s basis in the shares beginning on the first date upon which the S election is effective. This basis is fixed by determining the shareholder’s original basis in the stock in the corporation and then by making any adjustments occurring during the period the corporation was a C corporation. For example, the basis of the stock during the period the corporation was a C corporation may be adjusted for distributions that exceed earnings and profits, stock dividends, reorganizations, partial liquidations and certain redemptions.
C. **Increases to Basis in Stock.** Under Section 1367(a)(1)(A) and (B), separately and nonseparately stated items of income generally increase a shareholder’s basis in his stock. An item required to be included in gross income, but not actually reported on the shareholder’s return, does not increase the shareholder’s basis in his stock or debt. IRC Section 1367(b)(1).

1. **Depletion.** A taxpayer may take percentage depletion even though the taxpayer’s basis in the property has been reduced to zero. To preserve the benefit of the percentage depletion allowance, Section 1367(a)(1)(C) provides that depletion taken by the S corporation increases the shareholders’ bases in their respective shares of stock. The increase in stock basis for percentage depletion occurs only if the S corporation claims percentage depletion on non-oil or gas properties. Reg. § 1.1367-1(b)(1). Because cost and percentage depletion with respect to oil and gas properties is determined and deducted at the shareholder level (rather than the corporate level) there is no need to increase stock basis for depletion in excess of the basis of an oil and gas property. IRC § 1363(b)(2).

2. **Items Excluded from Gross Income.** An increase in stock basis for tax exempt income will arise to the extent that the tax exempt income is treated as an item of income "which could affect the liability for tax of any shareholder" under Code Section 1366(a)(1)(A).

3. **With Respect to Each Share of Stock.** Because income passes through on a per share, per day basis, increases to the basis in a shareholder’s shares are made on a pro rata basis with respect to each share, even if the shareholder has different bases in his shares. Reg. § 1.1367-1(b)(2), (c)(3).

D. **Decreases to Stock Basis.** Stock basis is decreased by the following items: (i) distributions not includable in income; (ii) separately stated items of loss and deduction; (iii) any nonseparately stated loss determined under Section 1366(a)(1)(B); (iv) any expense of the S corporation not deductible in computing taxable income and not chargeable to a capital account; and (v) the amount of a shareholder’s deduction for depletion for any oil or gas property held by the corporation to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the shareholder.

1. **On a Share-by-Share Basis.** Consistent with the treatment of basis increases, downward adjustments to basis are determined on a per share basis and that basis in separate shares of stock is not pooled or aggregated. IRC § 1.1367-1(c)(3).
E. **Basis Attributable to Indebtedness of S Corporation to Shareholder.** A principle distinction between a partnership and an S corporation is the treatment of entity-level indebtedness. Partners may often include a share of partnership debt in their respective bases in their partnership interest. Shareholders of an S corporation cannot include in their basis any share of corporation debt. Rather, shareholders obtain basis to absorb their share of S corporation losses only with respect to their bases in "indebtedness of the S corporation to the shareholder." IRC § 1366(d)(1)(B).

1. **Related-Party Loans.** Shareholders cannot increase basis if the indebtedness of the corporation to the shareholder is indirect. Accordingly, loans to an S corporation by other corporations, estates, partnerships and trust whose beneficiaries or owners were shareholders in the S corporation do not result in any indebtedness of the S corporation to the shareholders and therefore do not provide basis to the shareholders.

2. **Effect of Shareholder's Guarantee on Corporate-Level Indebtedness.** Before the time a shareholder makes payment on a guarantee, a "liability" may exist but no actual S corporation/shareholder indebtedness is considered to arise. This general view is premised upon the legislative history of subchapter S which indicated that this rule was to limit the amount of S corporation losses that could be deducted by a shareholder to the shareholder’s "investment" in a corporation. The term "investment" has been interpreted to mean "actual economic outlay" of the shareholder in question.

3. **Original Basis in Indebtedness.** The shareholder’s original basis in the loan to the corporation generally equals the amount loaned to the corporation. However, if a shareholder term loan does not bear adequately stated interest, the shareholder’s original basis of the loan will be less than the stated principal of the loan.

4. **Decreases in Basis of Debt.** A shareholder’s basis in indebtedness of the corporation is decreased only after his basis in his stock has been reduced to zero. With two exceptions, debt basis is decreased by the same items that decrease stock basis. First, tax-free distributions made to the shareholder decrease stock basis, but not debt basis. Second, repayments of the principle portion of the debt reduce the basis of the debt.

5. **Restorations of Debt Basis.** If the basis of a shareholder’s debt has been reduced by the pass through of losses, the shareholder’s share of
the net increase in basis restores the basis of the debt. The allocation of the net basis increase for the year restores debt basis before it increases the shareholder's basis in the stock. The debt basis restoration rules apply only to debt held by the shareholder on the first day of the taxable year in which the "net increase" arises. Reg. § 1.1367-2(c)(1).

6. **Effect of Repayment of Liabilities Having Reduced Basis.** Principle repayments received with respect to a note are treated as having been exchanged for a portion of the debt. IRC §§ 1271(a)(1), 1275(a)(1)(A). Accordingly, amounts received with respect to a written note that constitutes a capital asset in the hands of the taxpayer results in capital gain to the extent of the excess of the payments received over the basis of the debt. In contrast, payments received with respect to a debt not evidenced in writing (so called "open account" debt) do not qualify as a sale or an exchange and therefore result in ordinary income.

F. **Timing and Order of Adjustments to Stock Basis.** Adjustments to the basis of stock are generally made at the end of the taxable year. Reg. § 1.1367-1(d)(1). Accordingly, a shareholder's basis in his stock at the end of the year generally determines whether losses allocated to the shareholder during the year are allowable.

1. **Transfers of Shares Before End of Year.** If a shareholder transfers shares of stock before the end of the S corporation's year, basis is determined with respect to the transferred shares immediately before the transfer. Therefore, although an S corporation's year does not close with respect to the shareholder and losses do not pass through to the shareholder until the end of the S corporation's year (except in the case of a death), losses and income attributable to the pretransfer portion of the year adjust the basis of the transferred stock before the transfer. Consequently, if a shareholder transfers all of his shares before the end of the year, his basis in the shares immediately before the sale determines the amount of loss that may pass through to him. Reg. § 1.1367-1(d)(1).

2. **Order in Which Income, Losses and Distributions Adjust Basis.** Basis is first increased by income, is then decreased by losses, and finally is decreased by distributions. Reg. §1.1367-1(e). The 1367 regulations create an internal ordering rule for the pass through of items (other than distributions) that reduce basis. Under this rule, decreases for noncapital, nondeductible expenses reduce basis before items of loss or deduction.
Example. A, the sole shareholder of X, an S corporation, has a basis of $20 in his stock. X has $20 of deductible business expenses and $5 of nondeductible business meal expenses (a noncapitalized item under the Section 1367 Regulations). Under the Section 1367 Regulations, basis is reduced first by the $5 in nondeductible, noncapitalized expenses, then by $15 in deductible expenses. The remaining $5 of deductible expenses is carried forward under Section 1366(d). Under the applicable partnership rule, 20/25th of the $20 in items that pass through ($16) would be deductible expenses, and the remaining 5/25ths ($4) would be nondeductible, noncapitalized items. The remaining $5 carried forward under Section 704(d) would consist of $4 in deductible expenses and $1 in nondeductible expenses.

Taxpayers may irrevocably elect to have deductible items pass through before nondeductible, noncapitalized items. Reg. § 1.1367-1(f). If this election is made, the results in the above example change, the full $20 in deductible expenses passes through before the $5 in nondeductible, noncapitalized items.

G. Timing and Order of Adjustments to Debt Basis. Corporate losses passed through to a shareholder reduce the shareholder’s basis in the indebtedness of the corporation to him only after the basis of his stock has been reduced to zero. Conversely, before the basis of stock is increased by a shareholder’s share of income passed through to him, the basis of the indebtedness of the corporation to the shareholder is first increased by the income passed through until the basis of the debt has been restored. IRC Section 1367(b)(2)(B).

H. Treatment of Losses in Excess of Basis - In General. The shareholder may deduct losses allocated to him only to the extent of his basis in his stock and indebtedness of the corporation. Any loss disallowed under the basis limitation may be carried forward indefinitely. The transfer of all of the shareholder’s shares will, however, apparently result in the loss of such carryovers.

1. Pass Through When Shareholder Has Differing Bases in Shares. Downward adjustment to basis are determined on a per share basis. If a reduction to basis attributable to a particular share exceeds the basis of the share, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock of the shareholder, proportionate to the shareholder’s remaining basis in each of the remaining shares. Reg. § 1.1367-1(c)(3).
III. AT RISK LIMITATION ON PASS THROUGH OF LOSSES

A. **Introduction.** Congress designed the at risk rules under Section 465 to curb the increasing use of nonrecourse debt and tax sheltered investments that enabled taxpayers to increase their bases in deduction-producing assets without economic risk. Thus, the at risk rules under Section 465 prevent the use of net losses from activities to which a taxpayer is not economically at risk. The at risk rules apply to the shareholders of an S corporation.

B. **Deduction Limitation.** Section 465(a) limits the loss allowed to the taxpayer from an activity for a given taxable year to the "aggregate amount with respect to which the taxpayer is at risk" in that activity at the close of that taxable year. The term "loss" for this purpose means net loss from the activity.

C. **Role of Corporation in Determining Amount At Risk and Applicability of At Risk Rules.** The amount at risk at the corporate level is irrelevant. Instead, each individual shareholder determines his individual amount at risk at the shareholder level. IRC § 465(a)(1). Although the determination of the amount at risk is made at the shareholder level, the determination of whether the at risk rules apply to a particular activity is probably made at the corporate level.

D. **Shareholders to Whom At Risk Rules Apply and Determination of Amount at Risk — In General.** The at risk rules apply to individuals, to estates and trusts taxable as such, and to the deemed owners of deemed owner trusts (which generally describe the class of persons permitted to hold shares in an S corporation). IRC § 465(a)(1)(A). A taxpayer's amount at risk with respect to an activity includes: (i) the amount of money and the adjusted basis of property contributed to the activity by the taxpayer, and (ii) specified amounts borrowed with respect to the activity from certain persons. A taxpayer may not include borrowed amounts in his amount at risk unless: (i) he is personally liable for the borrowed amounts, (ii) he has secured the borrowed amounts with property not used in the activity, or (iii) he is engaged in the activity of holding real property, and he holds qualified nonrecourse financing that is secured by real property used in the activity. IRC § 465(b). Qualified nonrecourse financing is any financing: (i) that is borrowed by the taxpayer with respect to the activity of holding real property; (ii) that is borrowed from or guaranteed by a federal, state, or local government or is borrowed from a qualified person (lending institution or some related parties); (iii) except as provided in regulations, with respect to which no person is personally liable for the repayment; and (iv) that is not convertible debt. IRC § 465(b)(6). Furthermore, a taxpayer's amount at risk generally does not include any amount borrowed from: (i) a person that
holds an interest in the activity (other than an interest as a creditor), or (ii) a related person to a person (other than the taxpayer) holding such an interest in the activity. IRC § 465(b)(3).

E. Time at Which Amount At Risk is Determined. If an S corporation engages in an activity subject to the at risk rules, the shareholders’ respective amounts at risk in the activity are determined as to the close of the S corporation’s taxable year, not each shareholder’s taxable year.

F. Activities To Which At Risk Rules Apply. As originally enacted, Section 465(c)(1) provided that the at risk rules applied to the following four activities engaged in as trades or businesses or for the production of income:

1. Holding, producing or distributing motion picture films or video tapes;
2. Farming (as defined in Section 464(e));
3. Leasing any Section 1245 property (as defined in Section 1245(a)(3)); and
4. Exploring for or exploiting oil and gas resources.

Congress expanded the list of activities to include the activity of exploring for or exploiting geothermal deposits (as defined in Section 613(e)(3)) as well as any other activity engaged in by a taxpayer as a trade or business or for the production of income, unless otherwise exempted. The at risk rules also clearly apply to the activity of holding real property, subject to the qualified nonrecourse financing rules.

Section 465(c)(4) exempts from the at risk rules deductions attributable to the equipment leasing activities of specified closely held C corporations. Moreover, Section 465(c)(7)(A) exempts from the at risk rules deductions attributable to active businesses conducted by specified closely held C corporations. The amnesty granted by these sections may be important in choosing between C corporation and S corporation status.

G. Carryover of Suspended Section 465 Loss. Any Section 465 loss suspended by the at risk rules for a given taxable year is carried over to the next taxable year. The carryover continues on an unlimited basis until the suspended Section 465 loss is allowed.

H. Dispositions of Interests in Activity, Including Disposition of Stock. When a taxpayer disposes of an interest in an activity, gain arising from the disposition is treated as income from the activity and suspended Section 465 loss with respect to the activity is allowed to the extent of the gain. For this
purpose, the disposition of a shareholder’s stock in an S corporation is treated as the disposition of a portion of his interest in the activities conducted by the S corporation.

IV. LIMITATIONS ON LOSSES FROM PASSIVE ACTIVITIES

A. General Operation of Passive Activity Loss Rules. The passive activity loss (PAL) rules were intended to prevent a taxpayer from losses attributable to a tax shelter arrangement in which the taxpayer did not materially participate from offsetting income attributable to positive sources such as trade or business activities in which the taxpayer materially participated, wages, dividends and interests. Portfolio income and compensation income are not treated as passive income. Portfolio income includes interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business. IRC § 469(e). Each shareholder of an S corporation must treat separately his share of the items of the S corporation that constitute passive, nonpassive or portfolio income.

Losses that cannot be used in a particular year under the PAL rules are carried forward to future years, to be used to offset income attributable to passive activities in those years. Further, losses suspended under the PAL rules with respect to an activity may be used to offset nonpassive income upon the taxpayer’s taxable disposition of his entire interest in the activity.

The PAL rules generally apply to individuals, estates and trusts, and consequently, the PAL rules apply to shareholders of an S corporation. The PAL rules do not apply to an S corporation itself. Temp. Reg. § 1.469-2T(e)(1).

Because the PAL rules apply only to losses from passive activities, the definition of a passive activity is important. An activity is typically treated as a passive activity only if the activity is a rental activity, or the activity constitutes a trade or business activity and the taxpayer does not materially participate in the management of the trade or business activity. IRC § 469(c)(1). Rental activities are typically treated as passive activities even though the taxpayer materially participates in the rental activity. IRC § 469(c)(2).

The temporary regulations under Section 469 generally determine material participation by reference to various mechanical tests, principally based upon hours committed to a particular activity or series of activities. Although the taxpayer’s material participation in an activity is determined on a year-by-year basis, in some circumstances a taxpayer will be deemed to materially
participate in an activity in the current year based upon material participation in prior years. Temp. Reg. § 1.469-5T(a)(5).

B. **Treatment and Allocation of Interest Deductions - In General.** Generally, if interest is attributable to a passive activity the interest will be treated as a passive loss deduction and will be subject to the PAL limitation. Temp. Reg. §§ 1.163-8T(a)(4)(i)(B), 1.469-2T(d)(1)(i). If interest expense is attributable to property held for investment the interest will be subject to the investment interest limitation. Finally, if interest constitutes personal interest, the interest will be nondeductible. IRC § 163(h)(1). Under temporary regulations, the allocation of interest is generally made by reference to the manner in which the debt proceeds to which the interest is attributable or allocated. In general, debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. Temp. Reg. § 1.163-8T(a)(3).

1. **Allocation of Interest Attributable to Corporate-Level Debt.** Debt incurred by an S corporation is allocated in accordance with the manner in which the proceeds of the debt are used by the corporation. Consequently, interest attributable to the allocated debt is then characterized in accordance with the allocation of the debt. Temp. Reg. § 1.163-8T(c)(1).

2. **Shareholder-Level Debt Attributable to Stock Purchase from Another Shareholder.** Interest expense on debt incurred by a shareholder to purchase stock in an S corporation is allocated among the various assets and activities of the S corporation. Notice 89-35 provides that the proceeds of shareholder debt incurred to acquire S corporation stock from another shareholder may be allocated among the S corporation’s assets in accordance with some reasonable method selected by the taxpayer. See PLRs 9215013, 9037027. For this purpose, a reasonable method of allocation includes a pro rata allocation based on the fair market value, book value or adjusted basis of the S corporation’s assets.

   A significant difference between the allocation of corporate level debt and shareholder debt incurred to purchase stock exists in that corporate level debt is allocated on a use of proceeds basis, while shareholder level debt incurred to acquire stock from another shareholder is generally allocated on some pro rata basis.

3. **Capital Contributions and Purchases of Stock from S Corporation.** Notice 89-35 provides that a shareholder who acquires stock from the S corporation or who makes a contribution of capital to the S
corporation must use some reasonable method to allocate the proceeds attributable to debt used to acquire the stock or to make the contribution. For this purpose, a reasonable method apparently includes the allocation of debt in the same manner as if the shareholder had acquired stock from another shareholder. Alternatively, the shareholder acquiring stock from the S corporation or making a contribution to capital funded by indebtedness may allocate interest in accordance with the S corporation’s actual use of the proceeds of the stock purchase or capital contribution.

C. **Compensation Paid to Shareholders.** No portion of a shareholder’s share of the S corporation’s income allocated to the shareholder will be treated as compensation for personal services. Temp. Reg. § 1.469-2T(c)(4), (ii). Consequently, shareholders of an S corporation may increase their respective shares of income attributable to the passive activities of the S corporation (and thereby increase the passive income allocable to them) by foregoing compensation for services rendered. This assumes of course that the shareholder does not materially participate in the activity (unless the activity constitutes a rental activity). In other words, the payment of a lower salary to the shareholder materially participating in an activity would not increase passive income.