“S” Corporations

Chapter 4

New Law on “Pass-Thru” Income – Sole Prop., S Corp., PSP (-362.2 Billion)

Pass-Thru Tax Rate Relief

Conf. Version	
Deduction for 20% of Qualified Business Income (QBI) from PSP, S Corp, or Sole Prop.	
QBI of any T or B except specified service T or Bs and must be U.S. ECI (relief for service income below)	
QBI does not include guaranteed pyts to Ptrs for services or W-2 wages to S Shareholder	

QBI

QBI means income gain, deduction and loss effectively connected with a U.S. trade or business within the meaning of section 864(c)—substituting "qualified T or B" for "nonresident alien individual or foreign corporation" (Sec. 199A(c)(3))

QBI does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business" (aimed at S shareholders?)

Negative QBI is treated as a loss from qualified businesses in the following taxable year.

Service Businesses

Conference Version

A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. For this purpose a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (sections 475(c)(2) and 475(e)(2), respectively).

Deduction allowed in full for service bus. if TI not over 315K *MFJ*/157.5K other

Need for Payment of W-2 Wages

Conference	
The deduction is limited to 50% of W-2 wages paid.	
No W-2 wage requirement if TI not over $315K MFJ / $157.5K Other (W-2 limit phased in over next $100K/50K)	
No change	

Conference	
Includes REIT dividends and cooperative dividends	

Conference	
Deduction Allowed to Specified Agricultural or Horticultural Cooperatives (Sec. 199A(g))	
Allowed for Publicly Traded PSPs	
Allowed against AMT	

Conference

		Indiv. Bracket	Rate on QBI
		10%	8%
		12%	9.6%
		22%	17.6%
		24%	19.2%
		32%	25.6%
		35%	28%
		37%	29.6%

Penalty Mod.

"There is a substantial understatement ... if the amount of the understatement for the taxable year exceeds the greater of-

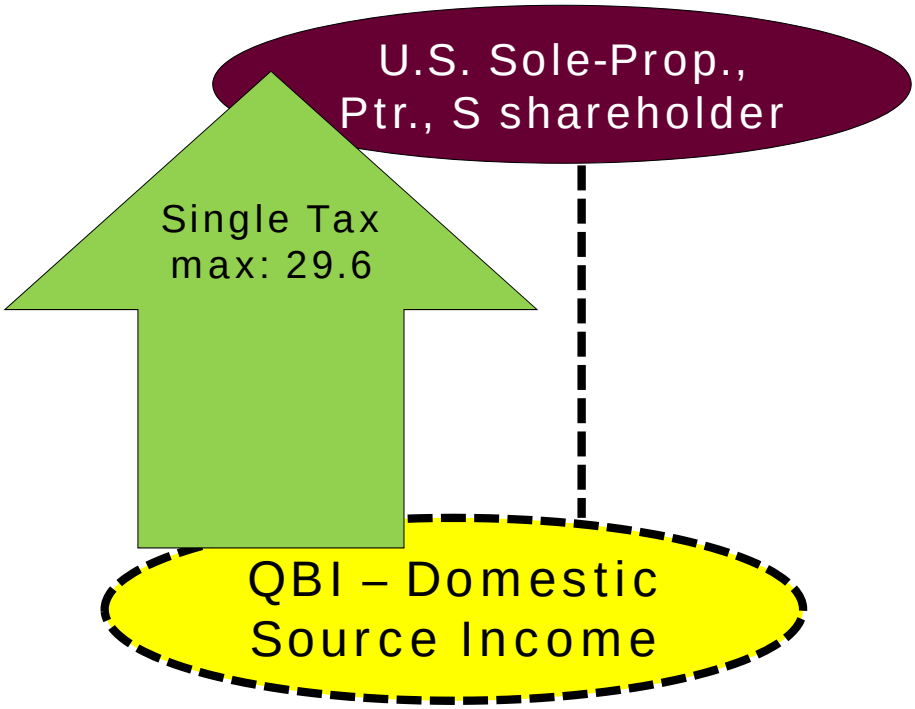
(i) ~~10~~ 5 percent of the tax required to be shown on the return for the taxable year, or

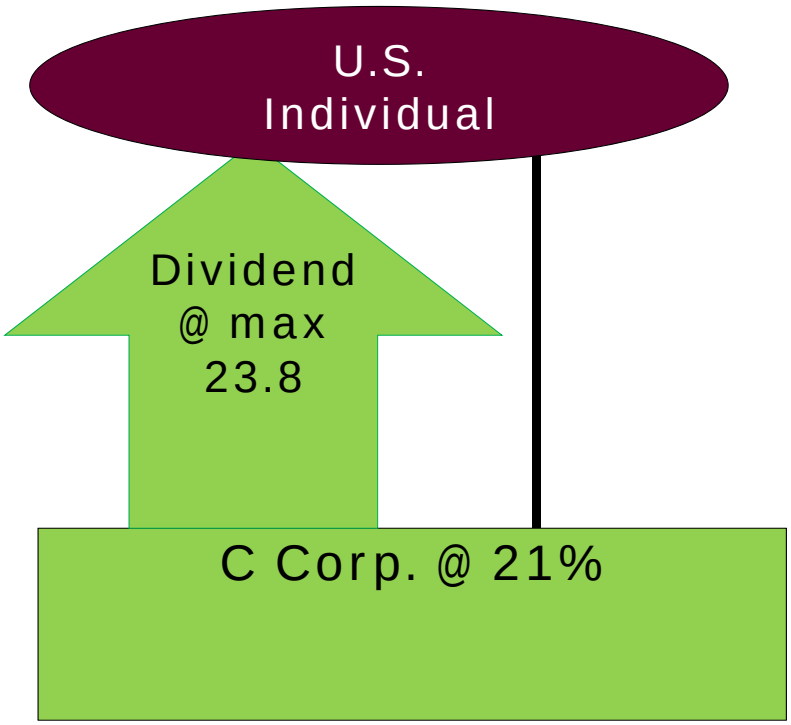
(ii) $5,000." (Sec. 6662)

Does Proposed Law 21% Rate for C Corps make them more attractive than "S"?

Rates

		Indiv. Bracket	Rate on QBI
		10%	8%
		12%	9.6%
		22%	17.6%
		24%	19.2%
		32%	25.6%
		35%	28%
		37%	29.6%


U.S. Sole-Prop., Ptr., S shareholder
Single Tax max: 29.6
QBI – Domestic Source Income


U.S. Individual
Dividend @ max 23.8
C Corp. @ 21%

Relief for Converting from S to C?

If same ownership of S corp after enactment and S status is revoked within 2 years of enactment, then:

- Distributions after the PTTP are characterized based upon the ratio of AAA/AE&P.

Section 481 adjustment for accounting method changes:

A “6 tax year period beginning in the year of change.”

Losses For Taxpayers Other Than Corporations (+137.4 billion)

An excess business loss is a taxpayer's net, aggregate current-year pass-thru loss above $250K for singles and $500K for MFJ. (both indexed for inflation).

- Excess business losses of a pass-thru business (sole-prop., S Corp., PSP) are not allowed for the taxable year.
- They are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years.

Goldsmith, TC Memo 2017-20 (1/26/2017)

4-1

Convicted Lawyer and Sole S Shareholder Loses Big in IRS Fight but Wins on One Key Issue: Attributed Wages

Background

- *Scott Singer Installations*, Inc. v. Commissioner, T.C. Memo. 2016-161 4-3
- Goldsmith relies on Scott Singer and IRS disagrees with Scott Singer in AOD 2017-04 (4/17/2017).
-

Scott Singer Installations

- Singer's retail store for recreational vehicles, initially profitable, was declining from 2008 to 2011 (an S corp).

- Taxpayer directly advanced funds to the S corp., and indirectly did so by charging business expenses to personal credit cards.

- The S corp. reported these advances as loans from shareholder on its general ledgers and its annual 1120S income tax returns.

- The "loans" were NOT documented -- no note, no maturity date, loan repayment schedule, interest rate, etc.

The S corp. showed operating losses in 2010 and 2011; however, during those years it paid $181,872.09 of Mr. Singer's personal expenses and treated those payments as loan repayments on the general ledgers and 1120S.

IRS characterized part of the S corp's payments of personal expenses as wages:

- $60,000 in 2010
- $59,037 in 2011

Singer Tax Court Holding

The Tax Court agreed that Scott Singer was:

1) An employee of the S corp.

and

2) That he performed "substantial services" for the S Corp.

The Tax Court reasoned that if the advances were loans, then the subsequent repayments (S corp paying personal expenses) were loan payments not wages.

- The Tax Court implies that if the advances were intended to be capital, then the repayments would potentially be wages.
- The Tax Court analyzed the factors that distinguish debt from equity.

The Tax Court determines that the advances between 2006 and 2008, a total of $649,443, were loans because "Mr. Singer had a reasonable expectation of repayment".

After 2008, the Tax Court determined that without a capital infusion, Singer could no longer have a reasonable expectation of repayment, so the advances were capital.

The Tax Court concludes that the S Corp had a sufficient outstanding loan balance at the time [2010 and 2011] the repayments were made [S corp's payments of Singer's personal expenses] so that loan repayments made during the years at issue are valid as such."

"Consequently",
said the Tax Court,
those repayments
"should not be
characterized as
wages subject to
employment taxes."

What is
conspicuously
absent from the Tax
Court's analysis?

Says the IRS in
AOD 2017-04

AOD 2017-04 (04/17/2017)

4-8

IRS Agrees in Result Only In Scott Singer Installations Inc., T.C. Memo. 2016-161

- Whether advances are debt v. equity does not control the question of whether payments are compensation for services.
- The Tax Court did not consider the possibility that the purported loan repayments were being made as remuneration for services.

The Court failed to "review its own substantial body of case law that repeatedly rejects taxpayers' attempted characterizations of payments to officers who perform substantial services as something other than compensation for services."

"The [employment tax] regulations expressly provide that an employer's characterization of the payment is irrelevant. Accordingly, when a corporation makes any payment of personal expenses to or on behalf of a shareholder-officer, the question must be asked - is the payment being made as remuneration for services?"

- The IRS Acquiesces "in result only"
- Meaning?
- Perhaps the IRS is willing to accept zero compensation because the S corporation was generating net losses in the years at issue.
  (the independent investor test supports low compensation)

Observation:

In *Glass Blocks Unlimited*, TC Memo 2013-180 (8/7/2013), the Tax Court, concluded that purported (undocumented) loans were, in reality, capital contributions and that the repayments were "wages"; however, the Tax Court does suggest that if the loans were bona fide debt, then loan repayments would not be wages.

Back to Goldsmith TC Memo 2017-20 (1/26/2017)

4-1

Facts

- Mr. Goldsmith is the sole shareholder of his S corporation – a law practice (G&A).

- Other than a big fee one year, his practice was constantly struggling and Mr. Goldsmith loaned large amounts to the S corporation to keep it afloat.

- Eventually, Mr. Goldsmith borrowed against his home and lost it and his practice.

- His license to practice law was suspended by the Minnesota Lawyers Board of Professional Responsibility in May 2004.

- He was convicted of failure to pay U.S. employment tax and failure to file Form 1040s (1999 – 2002) and served 33 months in prison.

- After release from prison, he faced a civil income tax audit for the same years.

Tax Court Holding

The IRS prevailed on all issues, including penalties, except the IRS determination of W-2 wages to Mr. Goldsmith from the S corporation.

"The Commissioner asserts that because Mr. Goldsmith was an employee of G&A ...payments made from G&A to him during the years at issue are constructive wages, which would make G&A owe more in payroll tax and Mr. Goldsmith owe more in income tax."

Mr. Goldsmith argues that because during those years G&A made no money, it could not have afforded to pay him wages, and any money he took out of G&A was to reimburse him for G&A expenses he himself had paid earlier."

"The first problem here is that the agent did not take into account any loans Mr. Goldsmith made to G&A. We also saw no indication that she considered G&A's operating expenses or whether she even asked herself if she had all the information necessary to make her determination.

She admitted that ‘with [her] experience now, [she] would have taken [expenses and loans] into much more consideration,’ and that since then she's learned a lot more.”

Judge Holmes: “There's no rule that an S corporation has to pay its sole shareholder a wage, especially when it's bleeding money the way G&A did. The real question is one of fact-were the payments a return of capital, repayments of loans, or wages? See *Scott Singer Installations....”*

“It's the same [as Singer] here. .... Even during the earlier years when he was able to use equity in his home to fund G&A, the business was running at a deficit. From 1997 through 2002 G&A had only one profitable year-2000, the year of the large contingent fee.

Even with that fee, however, G&A was still failing-as shown by the losses in the following years and Mr. Goldsmith's own acknowledgment.

For these reasons [consistent losses] we find that payments that G&A made to Mr. Goldsmith were not wages, as the Commissioner asserts, were not reimbursements for expenses as Mr. Goldsmith insists, but rather were a nontaxable return of capital to the extent of his basis."

Despite IRS disagreement with the logic of Scott Singer (in the AOD), the likelihood of IRS appeal on these facts is nonexistent in light of the IRS agent testimony and the pattern of consistent losses.

PMTA 2017-05 (March 30, 2017)

4-11

IRS Explains When the Tax Court has Jurisdiction on Disputes Involving Shareholder Compensation

Citing recent caselaw, per the PMTA, when the "dispute is limited to the correct amount of ... 'wages' for employment tax purposes, i.e. whether the additional payments constitute wages, rather than dividends or distributions, return of capital, loan repayments...", then the Tax Court lacks jurisdiction.

Per the PMTA:

Additional employment tax should be directly assessed which means that the taxpayer must pay the tax and challenge a refund denial in the U.S. District Court or the U.S. Court of Federal Claims.

4-12

CCA 201735021 (9/1/2017)

No Tax Court Review When IRS Recharacterizes Corporate Payments To S Corp. Employee-Officer

(the Taxpayer used a professional employer organization)

If the dispute involves worker classification (EE v. IC) or section 530 relief, then the Tax Court would have jurisdiction--so the IRS cannot immediately assess the employment tax.

4-13

Fleischer, TC Memo 2016-238 (12/29/2016) –

Income Reported By S Corporation Should Have Been Reported On Owner's Sch. C.

Facts

Taxpayer, Ryan Fleischer, is a financial consultant, developing investment portfolios for clients.

- On February 2, 2006, taxpayer "entered into a representative agreement with Linsco/Private Ledger Financial Services (LPL). The agreement expressly states that [taxpayer's] relationship with LPL is that of an independent contractor."

"After consulting both his business attorney and his CPA, petitioner incorporated Fleischer Wealth Plan (FWP) and caused it to elect S corporation status. .... On February 28, 2006, petitioner entered into an employment agreement with FWP."

"On March 13, 2008, petitioner entered into a broker contract with MassMutual Financial Group (Mass Mutual). The contract is between petitioner [as an independent contractor] and MassMutual-there is no mention of FWP [the S corp] in the contract"

- The S corporation, FWP, reported the income from LPL and MassMutual (which flowed through to Fleischer's Form 1040).
- IRS said the income belonged on Ryan Fleischer's Schedule C, thus triggering SE tax.

Tax Court Holding

There was no indicium for LPL to believe that FWP [the S corp] had any meaningful control over [Fleischer] as FWP had not been incorporated and no purported employer-employee relationship between FWP and [Fleischer] existed at the time [Fleischer] signed the representative agreement with LPL.

FWP is not mentioned in the MassMutual contract.

"[Fleischer] individually, not FWP [the S corp], should have reported the income earned under the representative agreement with LPL and the broker contract with MassMutual for the years in issue.

Sensenig, TC Memo 2017-1 (Jan. 3, 2017)

4-16

S Corporation Investments Were Equity Not Debt so $10,695,581 business bad debt loss denied

"Mr. Sensenig owns his own tax return preparation business, Group Support, Inc., an S corporation. At one time Mr. Sensenig prepared approximately 300 personal and business Federal tax returns a year, including all of his own..."

PLR 201725022 (June 23, 2017)

4-16

Rentals Not Passive Investment Income For S Corporation Purposes

IRS ruled that a corporation's rental income from owning and operating a medical office complex does not generate passive investment income for S corporation purposes.

4-18

Petersen, 148 TC No. 22 (June 3, 2017)

S Corp Can't Deduct Accrued Expenses Attributable To ESOP Participants Until Paid

Facts

- S corp., Petersen, uses the accrual method of tax accounting.
- In 2009 and 2010 Petersen accrued expenses for wages, vacation pay, and related payroll items on behalf of its employees.

If Petersen and its employees were "related persons," section 267(a) deferred the corporate deduction for these accrued but unpaid expenses-- until the year the expenses were paid and includible in the employees' income.

Section 267(e) provides that any amount paid or incurred by an S corporation and "any person who owns (directly or indirectly) any of the stock of such corporation" are deemed to be "related persons"

Section 267(c)(1) (constructive ownership rules) provides that "[s]tock owned, directly or indirectly, by or for a trust" shall be considered as being owned proportionately by its beneficiaries.

- During 2009 and 2010 Petersen maintained an employee stock ownership plan (ESOP) for its participating employees.
- During each year, some or all of the Petersen stock was owned by the related ESOP trust.

IRS contended that the ESOP trust is a "trust" within the meaning of section 267(c)(1), with the consequence that the trust beneficiaries--the Peterson employees who were ESOP participants--are deemed to have owned the Petersen stock held by the trust.

Tax Court Holding

Section 267(a) operates to defer Petersen's deductions for the accrued but unpaid payroll expenses of the ESOP participants to the year in which such pay was received by the ESOP participants and includible in their gross income.

4-19

Hargis, TC Memo 2016-232 (Dec. 21. 2016) –

Losses Disallowed; Evidence Insufficient To Show S Corp Debt Basis To Shareholders

Background

Section 1366(d)(1) limits the amount of losses and deductions the shareholder may take into account for any taxable year to the sum of her adjusted basis in the stock of the S corporation plus her adjusted basis in "any indebtedness of the S corporation to the shareholder".

Facts

During the years 2007 through 2010, the taxpayers (husband and wife) owned 100% of several S corporations whose primary business was the operation of nursing homes.

- The S corporations borrowed money from related entities (LLCs) and unrelated commercial lenders.
- For most of such loans, Bobby Hargis signed the notes as coborrower along with the S corporations.

- Sometimes the loans were guaranteed.
- Loan proceeds were advanced directly by the lending entity to the coborrowing S corporation.
- Loan payments were made by the S corporation, not by Bobby Hargis.

- S corporation losses were passed through to the taxpayers who claimed an increased debt basis due to Bobby's position as coborrower and sometimes as guarantor.

IRS denied the taxpayers the Form 1040 losses from the S corporation on the grounds that participation as a coborrower or guarantor of the loans does not increase the taxpayers basis in the S corporation.

Tax Court Holding

"As is often said, '[n]o form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation.

Prior to that crucial act, `liability' may exist, but not debt to the shareholders'."
Raynor v. Commissioner, 50 T.C. at 770-771.

"Generally then, section 1366(d)(1)(B) contemplates a direct loan by the shareholder to the corporation using his own funds, or at least using funds for which he will be held ultimately responsible."

The taxpayers cited *Selfe v. U.S.*, 778 F.2d 769 [57 (11th Cir. 1985), "for the proposition that a shareholder's guaranty or comaking of a third-party loan to the corporation should be treated as an investment by the shareholder in the corporation where 'the lender looks to the shareholder as the primary obligor.'

The Tax Court Distinguished Selfe:

"What initially happened in Selfe was a loan to the taxpayer directly, the proceeds of which she used to invest in her fledgling business. Only after that back-to-back transaction had taken place did the bank insist that the taxpayer refinance the line of credit in the name of the business."

Tax Court Conclusion:

"[W]e conclude that taxpayer's role as comaker or guarantor of the operating companies' notes did not entitle him to claim basis in the indebtedness of the operating companies under section 1366(d)(1)."

4-22

Tinsley, TC Summary Opinion 2017-9 (Feb. 28, 2017)

Guarantee of S Corp Debt Did Not Create Basis For Loss

"Mr. Tinsley concedes he had no stock or debt basis in Command Computers [the S Corp] at the time of its liquidation in 2010."

97

"However, he contends that upon the liquidation, he assumed the balance due on the note as guarantor, and because he was the sole remaining obligor, this assumption was a contribution to capital, allowing him to deduct the amount of Command Computers' losses."

98

Tax Court Holding

"[W]e believe that (1) even after its liquidation Command Computers continued to operate, and (2) the Bank continued to look to Command Computers as the primary obligor on the loan and expected it to make the loan repayments."

4-23

Phillips, TC Memo 2017-61 (April 10, 2017)

Judgments And Liens Against Shareholder-Guarantors of S Corp Loan Did Not Crete Debt Basis

Facts

"Mrs. Phillips owned 50% of an S corporation that did [real estate] development, and she and her husband (along with others) personally guaranteed bank loans financing this activity."

"When these development projects collapsed, the lending banks sued them on their guaranties and recovered judgments, which petitioners were unable or unwilling to pay."

Issue:

Does Mrs. Phillips get debt basis in the S corporation as a result of these legal judgments?

Tax Court Holding

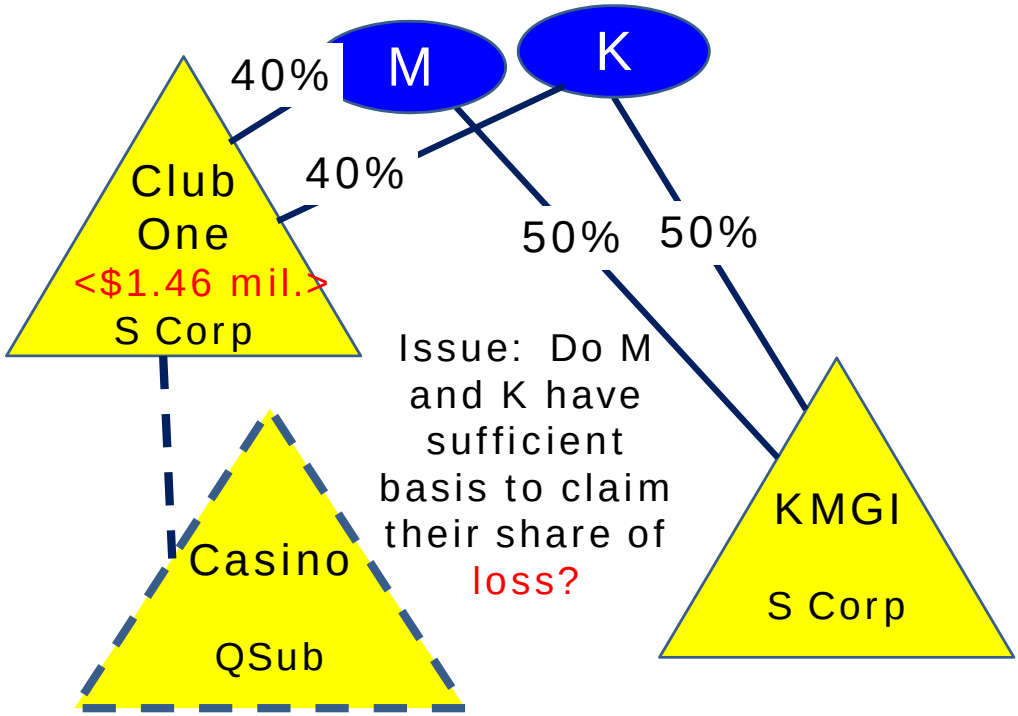
"We agree with [IRS] that the answer to this question is 'no'."

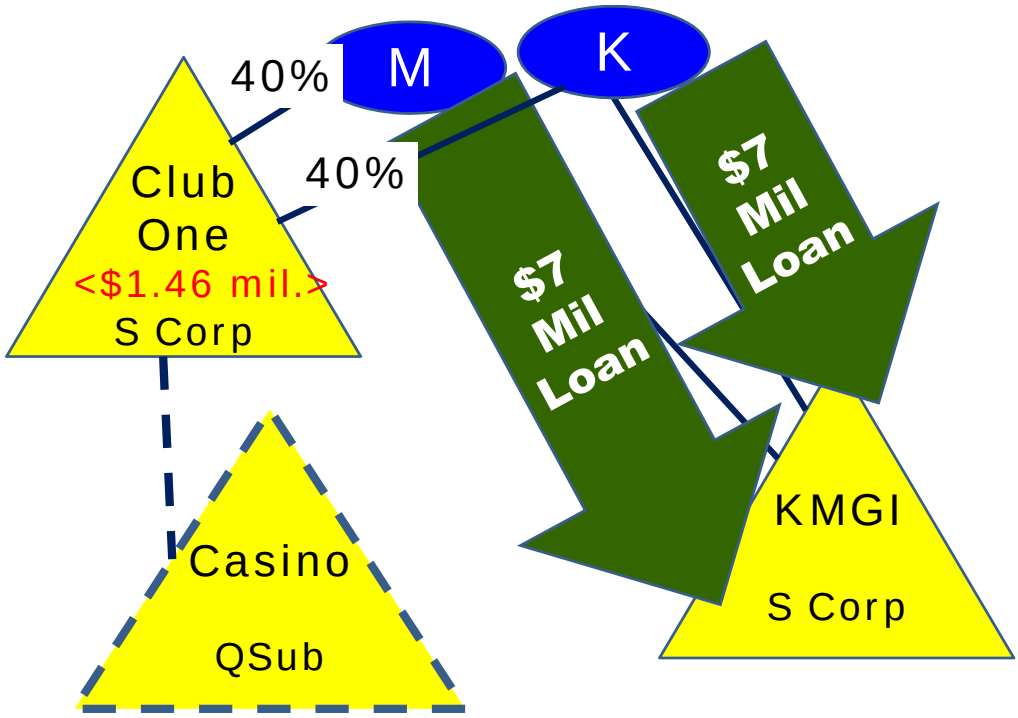
Messina, TC Memo 2017-213 (10/30/2017)

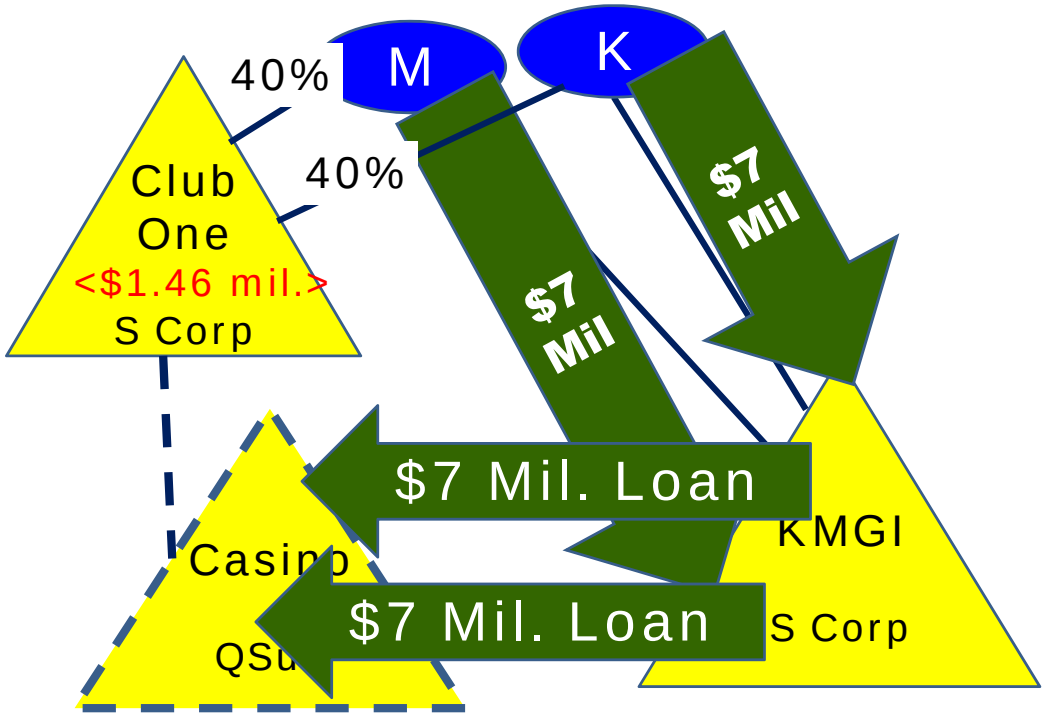
Supp

Tax Court Rejects S Corp #1 Shareholders' Attempt To Deduct Loss on Loan Via S Corp #2

The Transactions Simplified


M
K
40%
40%
50%
50%
Club
One
<$1.46 mil.>
S Corp
Casino
QSub
KMGI
S Corp
Issue: Do M and K have sufficient basis to claim their share of loss?


M
K
40%
40%
Club
One
<$1.46 mil.>
S Corp
Casino
QSub
$7 Mil Loan
$7 Mil Loan
KMGI
S Corp



IRS Position Sustained by Tax Court

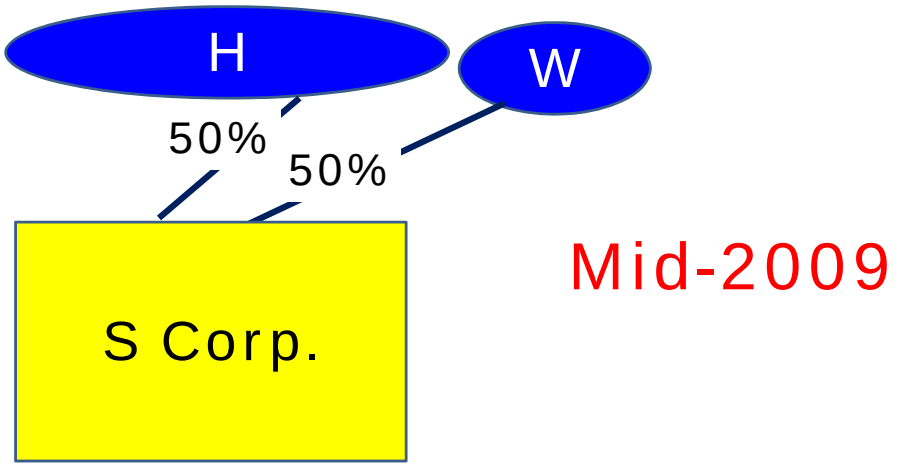
No debt basis to M and K; they made no economic outlay to Club One (KMGI did) and they are "bound by the form of the transaction they have chosen"

Smith
TC Memo 2017-218
(11/6/2017) Supp

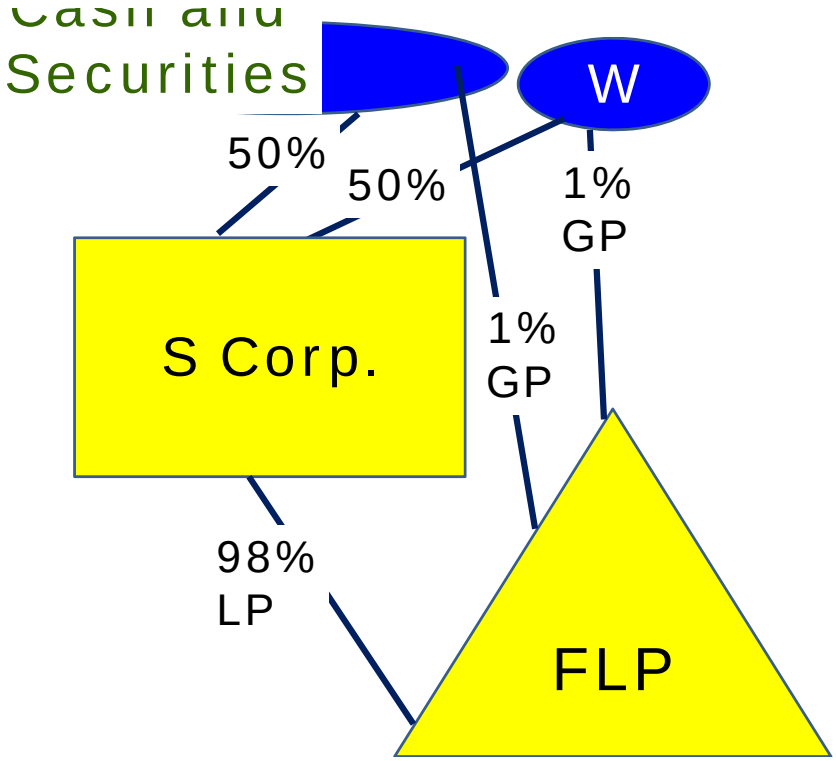
Creation Of S Corporation And PSP To Generate Tax Loss Lacked Economic Substance

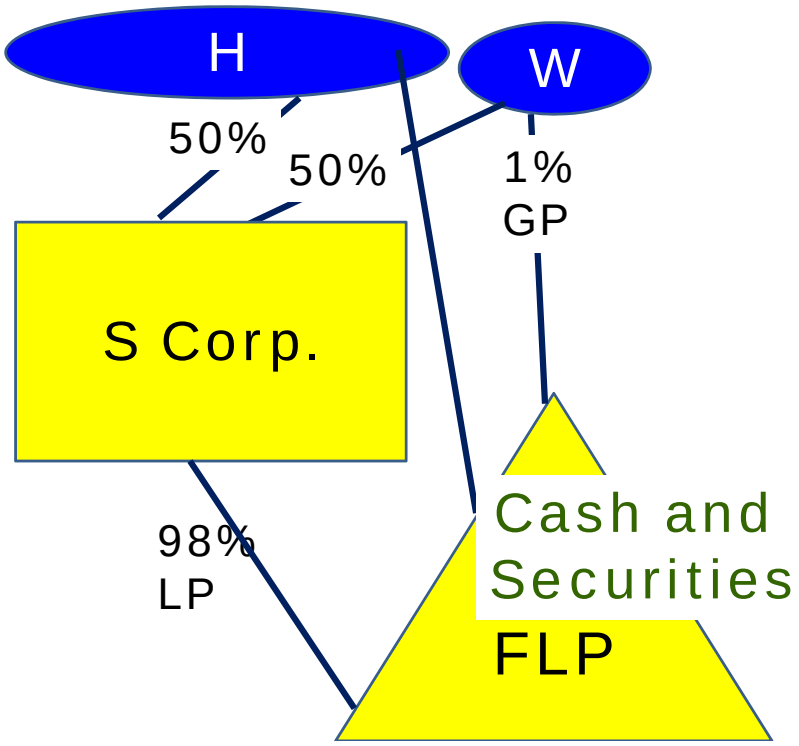
Tax Plan of Attorney and CPA

(same for "10 to 15 clients")


H
W
50%
50%
S Corp.

Mid-2009


Cash and
Securities
W
50%
50%
1%
GP
S Corp.
1%
GP
98%
LP
FLP



Next Steps:

- Discount the value of the S corp's 98% limited PSP interest in the FLP.
- On Dec. 15, 2009, liquidate the S corporation at a loss.

Tax Court Holding

- S Corp. lacked economic substance.
- No loss on “liquidation”
- + Accuracy Penalty