

11-1-1992

# S Corporation Current Developments

Annette M. Nellen

*San Jose State University*, [annette.nellen@sjsu.edu](mailto:annette.nellen@sjsu.edu)

S. S. Karlinsky

*San Jose State University*

Follow this and additional works at: [https://scholarworks.sjsu.edu/acc\\_fn\\_pub](https://scholarworks.sjsu.edu/acc_fn_pub)



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

---

## Recommended Citation

Annette M. Nellen and S. S. Karlinsky. "S Corporation Current Developments" *The Tax Adviser* (1992): 703-708.

This Article is brought to you for free and open access by the Accounting and Finance at SJSU ScholarWorks. It has been accepted for inclusion in Faculty Publications by an authorized administrator of SJSU ScholarWorks. For more information, please contact [scholarworks@sjsu.edu](mailto:scholarworks@sjsu.edu).

---

**Stewart S. Karlinsky,**  
Ph.D., CPA  
Graduate Tax Director  
San Jose State University  
San Jose, Cal.

**Annette Bomyea Nellen,**  
J.D., CPA  
Associate Professor  
San Jose State University  
San Jose, Cal.

# S Corporation Current Developments

## S Corporation Eligibility, Corporate Level Tax, Basis and Distribution Rules, Administrative and Procedural Changes, and Future Trends and Proposals

Since the Tax Reform Act of 1986 was enacted, the number of S corporation tax returns has more than doubled. With S corporations increasingly becoming the tax entity of choice, it is advantageous for practitioners to keep up with current developments in the area. This update will discuss recent court cases, IRS rulings, final and proposed regulations, and other developments through Aug. 31, 1992—specifically, S corporation eligibility issues; corporate level tax issues; basis and distribution rules; and administrative and procedural changes. The article will also survey future trends and legislative proposals that may affect S corporations in the coming year.

### S Corporation Eligibility Issues

#### ■ One class of stock

In 1990, the Treasury issued strict and controversial proposed regulations on the one class of stock rule; less than one year later, they were replaced by "gentler" proposed regulations.<sup>1</sup> Final regula-

---

<sup>1</sup>For a detailed discussion of both sets of proposed regulations, see O'Neil and Dennis-Escoffier, "Revised Proposed Regulations Clarify the One Class of Stock Rules," 23 *The Tax Adviser* 3 (Jan. 1992), and Dunn, "The One Class of Stock Requirement for S Corporations," 22 *The Tax Adviser* 34 (Jan. 1991).

*Authors' note:* The authors gratefully acknowledge the research efforts of Chiaming Chen, an MST student at San Jose State University.

*Editor's note:* Dr. Karlinsky is a member of the AICPA Tax Division's S Corporation Taxation Committee and is chairman of the Task Force on S Corporation Expansion.

THE TAX ADVISER ■ NOVEMBER 1992

tions, issued May 28, 1992,<sup>2</sup> took the 1991 proposed regulation approach that one class of stock is defined by the shareholders' right to pro rata distributions and liquidation proceeds. If a governing provision holds otherwise, the one class of stock rule would be violated. If an unequal distribution occurs and it is not done to contravene the one class of stock requirement, general tax concepts will be applied (compensation, imputed interest, etc.) to properly reflect the reality of the transaction. The final regulations are generally effective for tax years beginning on or after May 28, 1992, although the corporation and its shareholders may apply these rules retroactively.

#### ■ Qualified subchapter S trusts

Three revenue rulings were issued in 1992 on the qualified subchapter S trust (QSST) requirements. Rev. Rul. 92-48<sup>3</sup> held that a charitable remainder trust cannot be a valid QSST. Rev. Rul. 92-20<sup>4</sup> held that even though the terms of a trust do not require trust income to be distributed annually, as long as it is actually so distributed, it can be a valid QSST. Rev. Rul. 92-64<sup>5</sup> held that as long as only one beneficiary at a time is considered to receive the S income, over time there may be different beneficiaries.

IRS Letter Ruling 9235036<sup>6</sup> is representative of

---

<sup>2</sup>TD 8419 (5/28/92).

<sup>3</sup>Rev. Rul. 92-48, IRB 1992-26, 7.

<sup>4</sup>Rev. Rul. 92-20, IRB 1992-13, 18.

<sup>5</sup>Rev. Rul. 92-64, IRB 1992-33, 9.

<sup>6</sup>IRS Letter Ruling 9235036 (6/1/92).

a myriad of requests involving some technical mistake on the part of the QSST or its beneficiary, usually resulting in a Regs. Sec. 1.9100 ruling request. In this letter ruling, the beneficiary signed the Form 2553, Election by a Small Business Corporation, but did not timely file the Sec. 1361(d)(2) election. The Service held that the beneficiary was in "substantial compliance" with the rules and, therefore, a valid S corporation election was in effect.<sup>7</sup>

#### ■ Dual resident shareholder

In April 1992, the Treasury proposed amendments<sup>8</sup> to Regs. Secs. 301.6114-1 and 301.7701(b)-7, which affect an S corporation with a dual resident alien shareholder. If that shareholder claims a treaty benefit as a nonresident alien, then the S corporation has an ineligible shareholder, and its S status will be terminated. However, the proposed Sec. 7701 modifications include a special exception for the dual resident, who otherwise claims treaty benefits, to be an eligible shareholder. In effect, the shareholder and corporation must agree to have the tax and withholding rules that apply between a foreign partner and a partnership apply to the dual resident. The IRS plans to issue a revenue procedure to explain the withholding procedure required.

#### ■ Momentary ownership and affiliated group

IRS Letter Ruling 9215039<sup>9</sup> involved an S corporation that planned to spin off a business tax free under Sec. 368(a)(1)(D) to its shareholders. For one day, a parent-subsidiary relationship would exist. The Service held that under Rev. Rul. 72-320<sup>10</sup> this momentary ownership did not violate the S corporation eligibility rules for either the existing S corporation parent or the newly formed subsidiary.

### Corporate Level Tax Issues

#### ■ Passive investment income

There are two reasons why the amount of passive investment income (PII) is critical to an S corporation with subchapter C earnings and profits

(E&P): the S corporation termination provisions of Sec. 1362(d)(3) and the Sec. 1375 tax. On Apr. 17, 1992, newly proposed modifications to Prop. Regs. Sec. 1.1362-3 were issued,<sup>11</sup> which give additional examples of how passive income and gross receipts are computed and further define PII. Specifically, the regulations hold that income derived from the active conduct of a trade or business is not PII. They also refer to the personal holding company (PHC) rules for guidance (e.g., active computer software). For example, royalties derived in the ordinary course of a business of licensing property will not be PII. The regulations define "ordinary course" to include a company that created the property, performed significant services, or incurred substantial costs to develop or market the property.<sup>12</sup>

The proposed regulations state that interest income on obligations acquired in the ordinary course of a trade or business will likewise not be PII.<sup>13</sup> Thus, interest earned on inventory sales or the performance of services will not be PII; nor will gross receipts that are derived from the business of lending or financing; dealing in property; purchasing or discounting accounts receivables, installment obligations or notes; or servicing mortgages.<sup>14</sup> The effective date of these proposed modifications is for tax years beginning after Dec. 31, 1992. However, S corporations may elect to apply these rules retroactively to open post-1981 years by filing amended tax returns at the corporate and shareholder levels.

#### ■ Rental services income and PII

Three letter rulings in 1992 addressed the issue of how much and what type of activity is sufficient for significant services status. In one, the owner of an antique retail center provided advertising services to the lessees as well as layout and marketing advice, sign production and antique show promotions. The Service held that these activities were for the convenience of the tenant rather than for maintaining the condition of the space for occupancy; therefore, the gross receipts were not PII.<sup>15</sup>

In a pair of mobile home park rulings,<sup>16</sup> the

<sup>7</sup>For more information on inadvertent terminations, see Wil-guess, "Saving the S Election," 23 *The Tax Adviser* 107 (Feb. 1992).

<sup>8</sup>INTL-121-90 (4/27/92).

<sup>9</sup>IRS Letter Ruling 9215039 (1/13/92).

<sup>10</sup>Rev. Rul. 72-320, 1972-1 CB 270.

<sup>11</sup>PS-260-82 (4/17/92).

<sup>12</sup>Prop. Regs. Sec. 1.1362-3(d)(5)(ii)(A)(2).

<sup>13</sup>Prop. Regs. Sec. 1.1362-3(d)(5)(ii)(D)(2).

<sup>14</sup>Prop. Regs. Sec. 1.1362-3(d)(5)(iii)(B).

<sup>15</sup>IRS Letter Ruling 9234011 (5/20/92).

<sup>16</sup>IRS Letter Rulings 9234012 (5/20/92) and 9234013 (5/21/92).

maintenance of recreational facilities (pools, tennis courts, playgrounds, boat docks) elevated the activity to the level of significant services, based on Rev. Rul. 83-139.<sup>17</sup> Therefore, the rental gross receipts were not PII.

## Basis and Distribution Rules

### ■ Shareholder guarantees

Shareholders guaranteeing S corporation indebtedness continues to be a poor tax planning practice. The Tenth Circuit in *Goatcher*<sup>18</sup> and *Uri*<sup>19</sup> joined all decided circuits, other than the Eleventh, that guarantees do not give rise to shareholders' basis for loss. The "economic outlay" doctrine of *Est. of Leavitt*<sup>20</sup> was found to be more persuasive than the *Selfe*<sup>21</sup> decision.

**Tax planning:** A back-to-back loan arrangement would give rise to a superior tax result and still meet the lenders' needs. That is, the shareholder should borrow from the bank directly and lend to the S corporation. The S corporation note could secure the shareholder/bank note, which gives the bank indirect recourse to the corporate assets.

An inappropriate tax planning technique would be to have intercorporate loans distributed to the shareholder and assert that the notes would increase the shareholder's basis for losses. This strategy was tried in *Wilson*<sup>22</sup> and rejected by the court on the grounds that no real economic outlay was made by the shareholders.

### ■ Proposed Sec. 1367 regulations (basis of stock and debt)

A shareholder's basis in an S corporation is important in determining (1) the amount of gain or loss on sale of stock, (2) the deductibility of passed through losses and (3) the taxability of S distributions to the shareholders. A shareholder's note or loan receivable from the S corporation is also

important for the first two reasons cited. In June 1992, the Treasury issued Prop. Regs. Secs. 1.1367-1, -2 and -3 to provide further guidance.<sup>23</sup>

**Stock basis:** A shareholder's adjusted stock basis is first adjusted upwards by income items and then decreased by nondeductible/noncapitalizable expenses, by losses or deductions, and then by distributions. In general, these bases adjustments are done at the end of the corporation's tax year. However, if a shareholder disposes of any stock during the year, the adjustments are made for that stock immediately prior to the disposition.

**Debt basis:** If a shareholder's stock basis is reduced to zero (after taking into account current year adjustments), losses may be taken by the shareholder to the extent of year-end debt outstanding by the corporation to the shareholder. The shareholder's basis in debt would be reduced (but not below zero) by the amount of the loss. If the shareholder has multiple indebtedness, the loss should be allocated to each debt based on the ratio of that debt basis to all debt basis. Generally, the adjustments are computed at the end of the corporation's tax year. However, if the shareholder disposes of his entire stock interest, the adjustments must be made immediately prior to the disposition. Also, if debt is repaid in whole or in part during the year, restoration of basis (discussed below) will be made immediately prior to the first repayment.

**Restoration of debt basis:** When a shareholder's basis in debt has been reduced by S losses, any subsequent year S income will increase the debt's basis first (not to exceed the outstanding principal amount). This increase applies only to outstanding beginning of the year indebtedness.

**Effective date:** Officially, these regulations will be effective for tax years beginning after the final regulations are issued. However, if past history is any guide, the Service may allow a retroactive election.

### ■ Proposed Sec. 1368 regulations (distributions and AAA)

At the same time that the basis regulations were proposed, companion proposed distribution rules were also issued.<sup>24</sup> If an S corporation has subchapter C E&P, distributions are treated as coming from the accumulated adjustments account (AAA)

<sup>17</sup>Rev. Rul. 83-139, 1983-2 CB 150.

<sup>18</sup>*Homer Z. Goatcher*, 944 F2d 747 (10th Cir. 1991)(68 AFTR2d 91-5596, 91-2 USTC ¶50,450).

<sup>19</sup>*Lawrence R. Uri, Jr.*, 949 F2d 371 (10th Cir. 1991)(68 AFTR2d 91-5891, 91-2 USTC ¶50,556).

<sup>20</sup>*Est. of Daniel Leavitt*, 875 F2d 420 (4th Cir. 1989)(63 AFTR2d 89-1437, 89-1 USTC ¶9332).

<sup>21</sup>*Edward M. Selfe*, 778 F2d 769 (11th Cir. 1985)(57 AFTR2d 86-464, 86-1 USTC ¶9115).

<sup>22</sup>*Edward A. Wilson*, TC Memo 1991-544. See also *Sanford P. Burnstein*, TC Memo 1984-74, and *Jerry L. Shebester*, TC Memo 1987-246, which the court cited as support.

<sup>23</sup>PS-264-82 (6/9/92).

<sup>24</sup>Id.

and are tax free to the extent of the shareholder's stock basis. Any excess distribution is treated first as a taxable dividend out of E&P, then a return of capital and then a capital gain. If the corporation has any previously taxed income (PTI), the ordering rules are modified to count PTI as distributed after AAA but before E&P. Note that only a distribution of money will count as a PTI distribution. The PTI distribution reduces the shareholder's stock basis, but not AAA or E&P.

**Elections:** As discussed above, subchapter C E&P may cause the S corporation to terminate or pay an entity level tax. The proposed regulations provide three ways to facilitate the distribution of E&P: (1) an AAA bypass election, (2) a PTI bypass election and (3) a deemed dividend election.<sup>25</sup> This last election works like a consent dividend (Sec. 565), in which the shareholder is deemed to receive a distribution and recontribute the property back to the corporation. The amount of the deemed distribution may not exceed subchapter C E&P on the last day of the tax year reduced by any actual distributions of E&P during the year. All shareholders who own stock at the end of the year must consent.

**Terminating events and tax year:** If an election to close the books is made under Sec. 1377(a)(2), the Sec. 1368 distribution character rules apply using the same closing of the books method. If a shareholder disposes of at least 20% of the issued corporate stock in a 30-day period, the corporation may irrevocably elect to treat the qualifying disposition as triggering two tax years for allocating income and loss, and for adjusting AAA and E&P, etc.

**AAA:** The proposed regulations make it clear that the AAA may be reduced below zero, even though the shareholders may not get a current benefit for the loss due to limitations such as Sec. 469 or 1366(d)(1). If multiple distributions out of AAA (as opposed to out of E&P or PTI) occur during the year, the AAA should be allocated to each, based on the ratio of that distribution to all distributions. This parallels the treatment of current E&P. Similarly, the proposed regulations use Sec. 312(n)(7) concepts to adjust the AAA on a redemption, and Sec. 312(h) in the case of a tax-free corporate division.<sup>26</sup>

<sup>25</sup>Prop. Regs. Sec. 1.1368-1(f).

<sup>26</sup>Prop. Regs. Sec. 1.1368-2(d).

## Administrative and Procedural Changes

### ■ Fringe benefits

Rev. Rul. 91-26<sup>27</sup> held that accident and health insurance premiums paid by the S corporation are treated as compensation to a 2% owner-employee and must be reported as wages on Form W-2. Ann. 92-16<sup>28</sup> provides that the premium income is not subject to Social Security and Medicare tax as long as it is paid under a plan for employees and their dependents.<sup>29</sup>

**Caution:** Neither the ruling nor the announcement addresses several critical situations: self-insured plans; owners who are not employees; and other fringe benefits, such as cafeteria plans.

### ■ Statute of limitations

The courts have conflicting opinions on whether the statute of limitations tolls for S income and losses based on the entity's or the shareholder's time frame. This is not an uncommon issue, when contending with different year-ends, the filing of extensions and the granting of waivers. The Ninth Circuit is alone in holding that the S corporation's filing date controls for statute of limitations purposes.<sup>30</sup> The Tax Court and the Second,<sup>31</sup> Fifth<sup>32</sup> and Eleventh<sup>33</sup> Circuits all hold that the shareholder's tax return filing is determinative. Some certainty in this area should be forthcoming, as the U.S. Supreme Court has granted *certiorari* in the *Bufferd*<sup>34</sup> case.

**Practice tip:** If proposed legislation<sup>35</sup> or the Supreme Court focuses on the shareholder's tax return, the S corporation should keep its tax records for as long as the extended statute may run. If the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) audit procedures are involved, the statute is controlled by the notice of final S corporation administrative adjustment (FSAA) mailing date, the actions of the tax matters partner (TMP) and

<sup>27</sup>Rev. Rul. 91-26, 1991-1 CB 184.

<sup>28</sup>Ann. 92-16, IRB 1992-5, 53.

<sup>29</sup>Sec. 3121(a)(2)(B).

<sup>30</sup>*Daniel M. Kelley*, 877 F2d 756 (9th Cir. 1989)(64 AFTR2d 89-5025, 89-1 USTC ¶9360), rev'g and rem'g TC Memo 1986-405.

<sup>31</sup>*Sheldon B. Bufferd*, 952 F2d 675 (2d Cir. 1992)(69 AFTR2d 92-465, 92-1 USTC ¶50,031), aff'g TC Memo 1991-170.

<sup>32</sup>*Charles T. Green*, 963 F2d 783 (5th Cir. 1992)(70 AFTR2d 92-5077, 92-2 USTC ¶50,340), aff'g TC Memo 1991-78.

<sup>33</sup>*Robert Fehlhaber*, 954 F2d 653 (11th Cir. 1992)(69 AFTR2d 92-850, 92-1 USTC ¶50,131), aff'g 94 TC 863 (1990).

<sup>34</sup>*Bufferd*, note 31.

<sup>35</sup>HR 11, Act Section 4907.

Sec. 6229. Sec. 6229(d) can suspend the statute of limitations for up to one year and 150 days. In *Aufleger*,<sup>36</sup> "suspended" was interpreted to mean that whatever time was still remaining on the statute would be tacked on to the suspension period. For example, if an S corporation filed its tax return on June 6, 1985, the statute would normally expire on June 6, 1988. If an FSAA were mailed on Mar. 2, 1987, the statute of limitations could be suspended until July 30, 1988, and the balance of the statute period (one year, three months and five days) would be tacked on, making the new expiration date Nov. 4, 1989.

#### ■ Form 2553 filing

An age-old issue involves insuring that the S corporation's Form 2553 is received by the Service. In *Trimarco*,<sup>37</sup> the Sixth Circuit reversed and remanded to the lower court, holding that since the taxpayer and attorney provided affidavits confirming that the corporation filed the Form 2553, a valid S election may have been made.

**Planning tip:** A signed copy of the election and transmittal letter should be sent by certified mail, return receipt requested, and a copy should be kept by the taxpayer. If an acknowledgment is not received in three months, the Service should be contacted.

#### ■ Passive activities

Beginning in 1992, S corporations with more than one type of operation will need to consider new Prop. Regs. Sec. 1.469-4,<sup>38</sup> defining "activity" for purposes of Sec. 469. The new regulations replacing the temporary regulations<sup>39</sup> are much shorter and take a facts and circumstances approach to identifying a taxpayer's activities.

### Future Trends and Proposals

There are three areas of S changes in the wind that practitioners should be aware of.

<sup>36</sup>*William E. Aufleger*, 99 TC No. 5 (1992).

<sup>37</sup>*Trimarco*, 955 F2d 45 (6th Cir. 1992), not recommended for full text publication per Rule 24. See 1992 U.S. App LEXIS 3349 for full text.

<sup>38</sup>PS-01-89 (5/15/92). The proposed regulations generally are to be effective for tax years ending after May 10, 1992, although the old regulations may still be applied for 1992.

<sup>39</sup>Temp. Regs. Sec. 1.469-4T; TD 8175 (2/19/88), amended by TD 8253 (5/12/89).

#### ■ Simplification

HR 11, the Revenue Act of 1992, includes several noncontroversial S corporation proposals that could become law this year. Title IV, Subtitle F, Part I of the bill includes the following seven S corporation simplification proposals.

1. The results reached administratively by the final one class of stock regulations would be codified as law.

2. Currently, the IRS does not have the authority to waive inadvertent, invalid or untimely S elections. The bill would give the IRS this authority, allowing S status even if one of the shareholders was ineligible. If a Form 2553 was not filed on a timely basis, the IRS would have the authority under Regs. Sec. 1.9100 to waive the tardiness for reasonable cause. The law would be effective for tax years beginning after 1982, making the law change retroactive to all open years.

3. Currently, the shareholder's basis adjustment ordering rules are income, loss and then distributions. HR 11 would change the order to income, distributions and then losses. This provision would be effective for tax years beginning after 1991.

4. Repeal Sec. 1371(a)(2) would be repealed, so that an S corporation could elect Sec. 338 when it acquires the stock of a C or S corporation, and could liquidate a transitory subsidiary or a more permanent one (see proposal 5, below) tax free under the liquidation rules of Sec. 332. This will clearly increase the flexibility of S status. It would apply to tax years beginning after 1991.

5. Sec. 1361(b)(2)(A), which prohibits affiliated group status, would be repealed. Thus, for tax years beginning after 1991, an S corporation would be allowed to own an 80%-or-greater subsidiary. The S corporation parent and its subsidiaries would not be permitted to file a consolidated return. However, if the C corporation subsidiary owns 80% or more of another subsidiary, the non-S corporations could file consolidated tax returns.

**Planning tip:** Affiliated group status would open up a partial end run around the Sec. 1374 built-in gains (BIG) tax. Currently, if a C corporation switched to S status and recognized a BIG but did not distribute the proceeds to the shareholder, the result of incurring two levels of taxes would be worse than if the C corporation had sold the property. An S corporation could drop BIG assets into a controlled C corporation tax free under Sec. 351

and then sell the assets with only one level of tax. 6. Pre-1983 S corporation E&P would be eliminated. This would simplify the compliance burden of corporations that have always been S corporations but which might have had tax-exempt interest income or key man life insurance proceeds that created E&P and its attendant complexities. This provision does not eliminate subchapter C E&P. This proposed change is effective for tax years beginning after 1991.

7. Currently, the interplay of the income in respect of a decedent (IRD) rules and S corporations is unclear. The bill would apply the partnership rules to S corporations effective for shareholders who die after the date of enactment.

Elsewhere in HR 11 is a provision to allow most passthrough entities to use any noncalendar year-end if it pays the Sec. 444 deferral tax. This would obviously spread out the tax preparer's work load. Note that HR 2735 has a provision to increase the number of eligible shareholders to 50 from 35.

#### ■ Expansion

The U.S. Chamber of Commerce has formed a coalition with the American Bar Association, the American Institute of Certified Public Accountants, and various small business and trade associations to elicit ideas and propose legislation to expand the efficacy of S corporations. Some of the suggested changes are:

- Maintain the 35-shareholder requirement but allow family members (as defined in Sec. 267(c)(4)) to count as one shareholder. This would allow multigenerational families to keep S status for their closely held corporations.
- Relax the QSST rules to allow multiple beneficiaries.

Allow nonresident aliens to be eligible shareholders and apply the partnership withholding rules of Secs. 1441-1446. This would facilitate the financing of entrepreneurial efforts.

Allow S corporations to own S stock.

Expand the safe harbor debt provisions to allow convertible debt and to allow ineligible shareholders to hold safe harbor debt.

Allow shareholder guarantees of corporate debt to increase their basis for loss, as partnerships do.

Adopt C corporation fringe benefit rules for S corporation owner-employees rather than the partnership treatment.

The coalition also endorses the first six provisions of HR 11 listed above.

#### ■ Limited liability companies

Currently, at least 17 states have passed legislation recognizing the status of a limited liability company (LLC). This operating vehicle combines the limited liability feature of S and C corporations with the flexible income and loss allocations and without the ownership restrictions that a partnership currently provides. In several letter rulings, the IRS has treated the LLC like a partnership.<sup>40</sup>

For intrastate business, when the state has enabling legislation, this entity may be the optimal tax vehicle. However, there are numerous interstate legal, international treaty and tax issues that need to be resolved before the LLC will become more widespread and replace the S corporation as the tax vehicle of choice. TTA

<sup>40</sup>IRS Letter Rulings 9226035 (3/26/92) and 9227033 (4/8/92). See also Rev. Rul. 88-76, 1988-2 CB 360 (Wyoming LLC is a partnership).

