THE TAX ADVISER

Current Developments in S Corporations

S Corporations

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EXECUTIVE SUMMARY

- The IRS has been liberal in granting inadvertent termination relief, granting it in situations involving terminations due to violations of the rules regarding the timing of elections, the type of corporation that will qualify as an S corporation, the number of shareholders the corporation can have, the type of entity that can be an eligible shareholder, the type of stock the corporation can issue, and the type of income it can generate.
- The courts held against taxpayers in a number of cases where the taxpayers tried to use the S corporation structure to shift income or evade taxes.
- The IRS has made it clear that each S corporation is entitled to its own $500,000/$2 million limitation on deductions under Sec. 179.
- Proposed regulations on basis for debt move away from the requirement of an economic outlay and adopt bona fide debt criteria, which may make it easier to use funds from related parties, back-to-back loans, and other methods to create basis.

During the period of this S corporation tax update (July 10, 2011–July 9, 2012), some major changes that directly affect S corporations took place, which will be discussed here. This article then presents some tax planning ideas for S corporations and their shareholders.

Qualifying to Be an S Corporation

A corporation must meet several requirements to qualify as an S corporation. Some of those requirements include the type of corporation that will qualify; the number of shareholders the corporation can have; the type of entity that can be an eligible shareholder; the type of stock the corporation can issue; and the type of income it can generate. In addition, there are several types of elections that the corporation or its shareholders must make to qualify as an S corporation, including an election to be treated as an S corporation; an election to treat a subsidiary as a qualified S corporation subsidiary; and elections by trusts to be treated as eligible shareholders. If any of the requirements are not met at any time, the corporation's S election will be inadvertently terminated. However, the taxpayer can request an inadvertent termination relief ruling under Sec. 1362(f) and, subject to IRS approval, retain its S status continuously. Congress requested that the IRS be lenient in granting inadvertent election and termination relief, and it is clear from the rulings presented here and in past years that the IRS has abided by congressional intent.

Elections

In all of the rulings this year, if the taxpayer could establish reasonable cause for not making a timely election and show that granting the relief would not prejudice government interests, the taxpayer was granted inadvertent termination relief as long as a proper election was filed within 120 days of the ruling. These rulings applied to the failure to file Form 2553, *Election by a Small Business Corporation*,[1] Form 8832, *Entity Classification Election*,[2] and Form 8869, *Qualified Subchapter S Subsidiary Election (QSub)*,[3] as well as the elections required by the beneficiary of a qualified subchapter S trust (QSST)[4] and the trustee of an electing small business trust (ESBT)[5] to be an eligible S corporation shareholder. The IRS also granted inadvertent termination relief when the wrong person (in these cases, the trustee and not the beneficiary) signed the election in Letter Rulings 201151004 and 201144018.[6]

A more complicated situation occurs when S corporation stock is held by a trust and the beneficiary dies. The trust can continue to hold the S corporation stock for two years. After that time, the trust must distribute the stock to individual shareholders or to a new trust that will qualify as either a QSST or an ESBT. Many times the stock is transferred correctly to a QSST or an ESBT, but the appropriate person forgets to make the required election and causes a termination. In those cases, the IRS granted relief from inadvertent terminations this year.[7]

Eligible Shareholders

Sec. 1361(b) restricts ownership in an S corporation to U.S. citizens, resident individuals, estates, certain trusts, certain pension plans (but not IRAs), and certain tax-exempt charitable organizations. In *Taproot Administrative Services*,[8] the Ninth Circuit reaffirmed that a Roth IRA is not an eligible S corporation shareholder.

Historically, S corporations have been more successful with the IRS if they request inadvertent termination relief before they are audited and the issue is decided in the courts. This year, the IRS issued inadvertent termination relief to S corporations that had shareholders who were corporations,[9] a limited liability company,[10] a partnership,[11] another S corporation,[12] a nonresident alien,[13] and nonqualifying trusts.[14] In each case, the S corporation rectified the problem upon discovery and agreed to make any adjustments required by the IRS. The IRS allowed the S corporation to retain its status in these situations, but it otherwise did not rule on the tax consequences of the transactions.

One Class of Stock

Sec. 1361(b)(1)(D) prohibits an S corporation from having more than one class of stock, defined as equal rights to distributions and liquidations (but not voting rights). *Santa Clara Valley Housing Group*[15] involved an S corporation owned by the Schott family using a technique, SC2, marketed by an accounting firm. The technique allowed the Schotts to convert ordinary income of the S corporation into distributions taxable as capital gains through a multistep plan involving the issuance of stock warrants. The key issue was whether the warrants were a second class of stock and therefore would invalidate the S status of the corporation and cause the distributions to be subject to tax as ordinary income under Sec. 301. The district court in California originally decided that the stock warrants were a second class of stock, but it is currently reexamining the terms of the stock warrants under the safe-harbor rules of Regs. Sec. 1.1361-1(l)(4).[16] Two letter rulings[17] issued this year allowed the S corporation inadvertent termination relief when warrants were issued.

Letter Ruling 201218004[18] presents a fairly typical redemption agreement based on fair market or book value purchase price that is allowed without causing a violation of the one-class-of-stock requirement. On the other hand, Letter Ruling 201216034[19] deals with a fairly complicated trust agreement where the primary beneficiary is the trustee and has discretion to distribute, substitute trust property, etc. The ruling holds that since the beneficiary is a qualified shareholder, the trust is an eligible shareholder.

Letter Rulings 201220024 and 201150030[20] involved S corporations that made non–pro rata distributions to their shareholders. When the corporations realized that this violated the one-class-of-stock requirement, they immediately rectified the situation. The government held that the termination event was inadvertent and allowed the S status to continue unbroken.

In an interesting Chapter 7 bankruptcy case, *In re Kenrob Information Technology Solutions*,[21] the shareholders had an agreement with the S corporation that a distribution would be made each year equal to the tax owed at the individual level at the hypothetical C corporation tax rate. In two years at issue, the corporation paid these taxes directly to the IRS on the shareholders' behalf. The court held that these payments were not fraudulent transfers. The contract only looked at the federal tax rate. If the state tax impact had been included and they lived in different states, then a second class of stock would have been in evidence.

Earnings and Profits

If an S corporation has subchapter C accumulated earnings and profits (AEP), it will be subject to a tax under Sec. 1375 on its excess net passive investment income if its total passive investment income exceeds 25% of its gross receipts. In addition, if an S corporation's total passive investment income exceeds 25% of its gross receipts for three years, its S election automatically terminates the first day of the fourth year.

A ruling with multiple sins being forgiven, Letter Ruling 201221008[22] involves three consecutive years of AEP with too much passive investment income, along with disproportionate distributions causing a second class of stock. The government permitted a retroactive deemed-distribution election to allow the S corporation not to be considered terminated. Likewise in Letter Rulings 201226013 and 201222003,[23] an S corporation with AEP and excess passive investment income for three years was allowed to retain its S status as long as the company made a deemed distribution of its AEP.

Change in Capital Structure Reporting

An important statutory change that affects S corporation administration is the enactment of Sec. 6045B, which requires any change in the capital structure of a corporation (including S corporations) to be reported within 45 days to the IRS and the shareholder.[24] What needs to be disclosed regarding a specified security (stock or debt) is a description of any organizational action that affects the basis of the specified security of the issuer; the quantitative effect on the specified security's basis resulting from the organizational action; and any other information the IRS may prescribe.

Corporate spinoffs and reorganizations would clearly be covered. What is unclear is what other actions that affect shareholder basis through the interaction of corporate and individual tax rules in the context of an S corporation would be included. For example, a distribution out of AEP would presumably not be a covered transaction. But what if the S corporation distributes cash out of the corporate accumulated adjustments account, which clearly affects shareholder basis under Sec. 1368?

Also, the IRS has recently issued a new Form W-9, *Request for Taxpayer Identification Number and Certification*, to better identify S corporation classification vis-à-vis a C corporation. This was done because, beginning in 2012, under the Sec. 6045 disclosure rules, if a covered security is acquired by an S corporation, adjusted basis reporting is required.

The Mortgage Forgiveness Debt Relief Act of 2007[25] enacted Sec. 6699, which originally imposed a penalty of $85 per shareholder per month (not to exceed 12 months) if the S corporation did not timely file its corporate return or it failed to provide information required on the return. The law applies to S corporation returns required to be filed after Dec. 20, 2007, and the penalty is imposed on the S corporation. The penalty is currently $195 per shareholder, which includes any person who was a shareholder during any part of the tax year, and applies to returns filed late or returns that fail to contain the information required to be disclosed under Sec. 6037. To calculate the penalty, shareholder husband and wife count as two shareholders.

> ***Example 1:*** *H* and *W* and their two children own all the stock of *XYZ* Corp. In October 2011, the children gift some stock to their spouses. In 2012, the S corporation is late in filing its Form 1120S, *U.S. Income Tax Return for an S Corporation*, or forgets to include the distribution amount on the Schedules K and K-1 on the return. The S corporation could be liable for a penalty of $14,040 ($195 × 6 × 12) for this innocent mistake.

What is particularly disturbing about this provision is that, rarely, if ever, is the date of distributions included on Schedules K and K-1. Yet Secs. 6037(a) and (b) require the S corporation to report this information to the IRS and the shareholders. This provision is a trap for the unwary since anything left off the Schedule K-1—intentionally or not—could potentially trigger the penalty.

Ensync Technologies[26] is not about a "boy band" but involves a high-tech S corporation whose major shareholder did not file a timely S corporation return under Sec. 6037, and the IRS imposed $6,408 of penalties under Sec. 6699. The taxpayer argued that he had included the Schedule K-1 items on his tax return and the nonfiling was inadvertent. The court allowed him a "reasonable cause" basis for waiving the penalties.

S Corporation Disparate Information Reporting

Dickerson[27] involves a scenario similar to the 1994 Nicolas Cage movie, *It Could Happen to You.* An Alabama Waffle House waitress received a tip in the form of a lottery ticket and won $5 million. She tried to transfer the ticket to a newly formed S corporation that she owned 49% of (the remaining 51% was owned by other family members) to avoid gift tax. The court held that she was subject to a gift tax on the 51% she gave away.

Penland[28] is a case in which the sole shareholder disavowed her ownership of an S corporation that included a miniature horse farm and used car dealership. The government found that she was nonetheless liable for the income generated by the S corporation.

In *Garavaglia*,[29] the IRS argued that taxpayers' two corporations for which they had made invalid S elections should nonetheless be treated as S corporations because the taxpayers intended them to be S corporations. The Tax Court rejected this argument, saying that compliance with the procedural rules, not intent, governed whether a corporation was an S corporation. The taxpayers claimed that distributions from the corporations were nontaxable loan repayments, but the Tax Court held that they were income distributions.

Rogers[30] involved a situation in which a tax attorney tried to use multiple S corporations and single-member LLCs to evade taxes and failed.

D'Errico[31] involved several S corporations in which the owner had taken loans from the companies. The court held that he showed no intent to repay the loans and treated them instead as distributions, which reduced his basis in the stock. The IRS successfully asserted that personal expenses paid by the corporation (such as renting his father's home as a bogus office and the costs of an airplane not used in the business) were disguised dividends, and that the taxpayer understated his capital gain income upon the sale or liquidation of the corporations.

Final Regulations on Controlled Corporations

T.D. 9522, which applies to tax years beginning on or after April 11, 2011, distinguishes a controlled group under Sec. 1563 from the affiliated group rules of Sec. 1561. There was concern that the new rules would limit some S corporations' Sec. 179 deduction. Many practitioners believed that because S corporations were defined as "excluded corporations," two controlled S corporations could each take a maximum Sec. 179 deduction and pass them through to their shareholders. Informal discussions with the IRS National Office reveal that the new regulations were not meant to limit the Sec. 179 deduction and that each S corporation will in fact be entitled to its own $500,000/$2 million limitation.

Wages and Self-Employment Taxes

Tax advisers should be aware of a National Research Program being implemented for 2010–2012 (involving 2,000 returns per year) on employment status (employee vs. independent contractor), reasonable compensation, S corporation distributions vs. salary, and matching taxpayer identification numbers. Fifteen hundred of the 2,000 returns per year will be from the Small Business/Self-Employed division. The program began in February 2010.

The *David E. Watson* case[32] represents exactly what the IRS is trying to ferret out with this program. An experienced accountant worked 35 to 40 hours per week, 46 weeks a year, but took a salary of only $24,000. In addition, he distributed more than $200,000 in cash to himself. This taxpayer's behavior echoes a long line of cases going back to *Radtke*,[33] *Spicer Accounting*,[34] *Joseph M. Grey Public Accountant*,[35] etc., in all of which S corporation owners failed in their attempt to avoid Social Security taxes by undercompensating themselves and instead taking money out as distributions. The court reclassified $67,000 of Watson's distributions as salary. It should not be a surprise to learn that the wage limit subject to Social Security tax for the relevant year was approximately $91,000. The Eighth Circuit[36] affirmed the district court decision.

In a case where the taxpayer had a similar goal, *Cave*,[37] a sole shareholder attorney treated himself and all his associates as independent contractors. The court held that all parties involved were “statutory” or “common law” employees and, therefore, the company should have withheld Social Security taxes. The taxpayer argued that Section 530 of the Revenue Act of 1978 should protect him, but it does not apply to statutory employees. This case was upheld by the Fifth Circuit.[38]

Aggregate vs. Entity Concept

One of the confounding issues within the passthrough entity tax world is the application of the entity or the aggregate concept to a specific transaction. That is essentially the issue in *Trugman*,[39] in which a wholly owned S corporation bought a home for the use of its shareholders. The shareholders tried to take a Sec. 36 first-time homebuyers’ credit, but the court said that the S corporation is not an individual as the purchaser was required to be under Sec. 36, nor could the house be the corporation’s principal place to live. The reader should note that the Sec. 121 $500,000 exclusion would likely not be available either. Presumably, the S corporation intended to use Sec. 119 (meals or lodging furnished for the convenience of the employer) to deduct normally personal items.

Basis, Losses, and Limitations

A major motivation for a corporation’s choosing S status is the ability to flow entity-level losses to its shareholders. To be able to use this benefit, shareholders must keep careful track of their stock and debt basis. As a matter of fact, in discussions with IRS personnel, by far the hottest area for IRS review is adjusted basis. A shareholder must overcome several hurdles before losses are deductible, including Sec. 183 (hobby loss), Sec. 1366 (adjusted basis), Sec. 465 (at-risk), and Sec. 469 (passive activity loss) rules. Several court cases, a proposed regulation, and rulings were issued relative to these loss limitation rules.

Proposed Regs. Secs. 1.1366-2 and -5, which were promulgated on June 11, 2012,[40] may be helpful, when finalized, to many taxpayers who use related entities to fund loss S corporation activities. Essentially, the regulations move away from the “economic outlay”/poorer-in-a-material-sense criterion of many court cases and instead use bona fide debt criteria. This may make it easier to use funds from related parties, back-to-back loans, and even, in some cases, the “incorporated pocketbook” concept. It may also allow “round tripper” lending where each leg of the transaction is bona fide.

For example, if an individual owns both a partnership interest and an S corporation interest, and the S corporation leases property from the partnership, the shareholder/partner may be able to borrow from the partnership (or take a distribution), lend to the S corporation on bona fide terms, and have the S corporation pay the rent. The crucial concept is: What is bona fide debt under general tax principles? The authors would argue, if the terms of the loan/note were similar to what an unrelated third party would lend at, then a bona fide debt would be present.

The proposed regulations also explicitly point out that guarantees and recourse debt arrangements will not give rise to Sec. 1366 basis for loss until they are actually paid. They also reiterate that Rev. Rul. 81-187[41] still applies to limit the ability to increase basis by a shareholder’s contributing his own unsecured demand note to the corporation.

Welch[42] is an interesting adjusted basis in debt case in that the funds came directly from a nonowner, nonrelated party. There was no discussion of the motive of the third person in contributing $600,000 directly into a durable medical equipment, home health care business. There might have been a relationship with one of the owners of the company or a dodge around Medicare rules, but this was never explored in the case. Instead, the judges decided based on the evidence that the “economic outlay” doctrine was not met by the legal owners and therefore the losses were suspended. Even if the new proposed regulation standard of “bona fide” debt was used, this case would probably have still failed the test given the lack of contemporaneous records, no payments of principal or interest for several years, little collateral provided, and no attempts to collect past-due debt.

Maguire[43] involved two shareholders (father and son) who owned both a profitable and a loss S corporation. At the end of each year, the profitable company owned substantial accounts receivable due from the loss company. At the end of each year, the taxpayers received distributions of the accounts receivable from the profitable company and then contributed them to the related loss company to increase their bases in the loss company stock enough to allow them to deduct its losses. The IRS disallowed the loss deductions. The court held that shareholders in two related S corporations were not prohibited from receiving distributions of assets from one of their S corporations and then contributing those assets into another S corporation to increase their basis in the latter. Here, the transactions did actually occur and petitioners were entitled to their claimed losses.

Barnes[44] involved a restaurateur who owned an S corporation that had losses. In one year, the taxpayer had insufficient basis to deduct the loss under Sec. 1366(d), but in the next year had enough basis to take the loss, but did not. Several years later, he took the suspended losses. The court held that the loss was usable in the earlier year and, since he did not use it then, he lost it. This is similar to the allowed or allowable logic for depreciation and a trap for the unwary.

Broz[45] is another case in which an S shareholder did not have sufficient basis for loss. The taxpayer owned several S corporations but did not properly set up a back-to-back loan strategy. Instead, he used the other corporation's stock as collateral on the loan, which did not give rise to an economic outlay. To make matters worse, the court held that the "at risk" rules of Sec. 465 had not been met either.

Built-in Gains Tax Holiday

The Small Business Jobs Act of 2010[46] modified Sec. 1374(d)(7) so no built-in gains (BIG) tax is imposed on an S corporation's net unrecognized built-in gain if the fifth year in the recognition period precedes the 2011 tax year; but it is *not* currently applicable to 2012. Nonetheless, some tax planning or unanswered questions may still apply to fiscal-year S corporations:

1. If an installment sale of built-in gain property had occurred in a

1. prior year, it may be advisable to recognize the gain in FY 2011, assuming it qualifies as an eligible year. It may even be prudent to trigger the installment gain by using the installment note as collateral for a loan.
2. If an asset was sold in FY 2011 on the installment basis that would be covered by these rules but recognized in FY 2012, would it be subject to Sec. 1374 gain recognition? Until clarified, it may be advisable to elect out of Sec. 453 treatment for the exempt year.
3. If the taxpayer's net recognized built-in gain is limited by taxable income in its sixth recognition period year (FY 2011) and in 2012 it is subject to BIG, is the 2011 suspended gain forgiven or subject to Sec. 1374 tax?
4. There seems to be a difference between which years qualify as eighth, ninth, or tenth for Sec. 1374 vs. the carryover basis rules of Sec. 1374(d)(8). For the former, tax year seems to be the criteria and, thus, in switching from a C fiscal year to an S calendar year, a corporation may have had a short taxable year.

For the carryover basis provisions, the law seems to look to 12-month periods. For tax years beginning in 2011, the congressional report on the BIG tax holiday law makes it explicit that five 12-month periods are required.[47]

Letter Ruling 201150023[48] involved a converted C corporation that received a prepayment on installment sales notes to avoid the Sec. 1374 tax liability. It is hard to tell with the redaction of dates, but it appears the conversion may have created some short years that were counted for its recognition period.

Anschutz[49] involves an S corporation that was subject to Sec. 1374. Rather than sell investments for cash, it tried to structure a variable prepaid future contract so that gain would not be recognized until after the 10-year recognition period lapsed. The Tenth Circuit upheld the lower court ruling that the transaction was a sale and Sec. 1374 would apply to the recognized gain.

Tax-Deferred Reorganizations

The flexibility engendered by the QSub disregarded-entity rules generated some merger-and-acquisition activity involving S corporations. For example, Letter Rulings 201144002 and 201144003[50] involved a C corporation that was owned by ineligible shareholders such as corporations and partnerships. The ineligible shareholders distributed their stock to its shareholders/partners in a taxable transaction per Secs. 311 and 301. It then formed a holding company to hold the stock of the active QSub subsidiary. The government held that this would be a qualified S corporation.

In Letter Ruling 201126023,[51] a foreign corporation owned by two trusts wanted to domesticate under state corporate law. It also wanted to elect S status and have the two owners be treated as ESBTs. The IRS ruled that this would be treated like an F reorganization and would not be subject to any tax under Secs. 357 and 361. However, the reorganization presumably would be subject to Sec. 1374 potential tax liability.

One issue that may arise more frequently as S corporations and QSubs are used in more-sophisticated situations is the application of Sec. 6501(c)(8) to extend the S corporation's tax return's statute of limitation for the nonfiling of Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*. In Chief Counsel Advice (CCA) 201206014,[52] an S corporation had five controlled foreign corporation disregarded entities. It did not file Forms 5471 as required by Sec. 6038. The statute of limitation for both the S corporation and the Form 1040 of the two major shareholders was extended due to this lapse. There is also a $10,000 penalty for each Form 5471 not filed.

In Letter Ruling 201219003,[53] two families owned an S corporation. To prevent family disputes from disrupting the corporate business, they dropped half the assets into a controlled corporation and did a split-off to one family. Interestingly, the IRS was somewhat concerned that they did not accumulate accounts receivable or hold back on satisfying payables so that there was no gamesmanship (assignment of income). Also, liabilities remained with the distribution corporation even though some property may have had a liability related to it. The IRS ruled under Secs. 368(a)(1)(D) and 355 that there was no gain to the distributing corporation or the receiving shareholders.

In *Recovery Group*,[54] involving a crisis-management company, an internal crisis caused a 23% shareholder to have his stock redeemed. The shareholder also received a $400,000 one-year covenant not to compete. The company deducted the covenant not to compete amount when paid, arguing that amortization under Sec. 197(d)(1)(E) only applied to substantial stock acquisitions. However, the court sided with the government and ruled that the appropriate treatment was 15-year amortization under Sec. 197(d)(1)(E).

Tax Planning

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[55] maintained the capital gain and dividend 15% tax rates for 2011 and 2012 and extended the alternative minimum tax patch for 2011. It also extended the suspension of the itemized deduction and personal exemption phaseout for 2011 and 2012. In addition, the act allows first-year bonus depreciation at 100% for assets acquired and placed in service on or after Sept. 9, 2010, and before Jan. 1, 2012 (before Jan. 1, 2013, for certain property). For assets placed in service in 2012, 50% first-year bonus depreciation applies.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduced the Social Security rate for employees and the self-employed by 2% for 2011, and the Middle Class Tax Relief and Job Creation Act of 2012[56] extended this reduction in the tax rate through 2012.

Small Business Jobs Act of 2010

The Small Business Jobs Act of 2010 expanded the dollar amount of new or used tangible personal property that may be expensed in the year placed in service under Sec. 179 to $500,000 for 2011. The phaseout of this tax benefit starts at $2 million and would be fully phased out for property acquired in the tax year that exceeded $2.5 million. For 2012, the maximum amount is $139,000 and the phaseout starts at $560,000.57 Note that the requirement of sufficient positive business income still applies. If the income (including salary) is not sufficient, then a carryforward is permitted.

Under the act, in an expansion of the Sec. 179 provision, for tax years beginning in 2010 and 2011, $250,000 of the $500,000 limit for the Sec. 179 deduction may be applied to qualified leasehold, retail, and restaurant improvements.58 This category of assets has a 15-year life, so it is likely that taxpayers that place these assets into service in these years will choose to apply Sec. 179 to them. If the Sec. 179 income limitation applies to a taxpayer for 2011, this category of asset carryover cannot be deducted under Sec. 179 in 2012. Instead, the remaining carryover amount is depreciated as property placed in service on the first day of 2011.59 This is a trap for the unwary.

Patient Protection and Affordable Care Act of 2010

The Patient Protection and Affordable Care Act of 201060 imposed an excise tax on amounts paid for indoor tanning services. This year, Treasury issued final and temporary regulations61 regarding how disregarded entities will be treated with regard to this excise tax. Under the new regulations, QSubs and other disregarded entities will be treated as separate entities for purposes of the excise tax on indoor tanning services. This treatment is consistent with the treatment for other excise taxes under Regs. Secs. 1.1361-4(a)(8) and 301.7701-2(c)(2)(v).

Zero Capital Gains Rate in 2011 and 2012

Because of the extension of the zero capital gains rate for individual taxpayers in the lower two tax brackets in 2011 and 2012, taxpayers should consider gifting appreciated S corporation stock to their children, grandchildren, or parents. In 2008, the tax law extended the "kiddie tax" to income (including capital gains and dividends) of 18-year-olds who do not provide more than half of their support, and to 19- to 23-year-olds who are full-time students62 and do not provide more than half of their own support. Thus, the 0% tax rate generally will be unavailable to students through age 23 unless they have significant earned income or possibly trust fund income that contributes to their own support.

This leads to a balancing act. Parents may hire a child to legitimately work for them and pay him or her enough to meet the 50% self-support test, but not so much that they exceed the first two bracket limits. Also, the parent will lose the dependency exemption.

> ***Example 2:*** The taxable income bracket limit for the first two brackets in 2012 is $35,350. Child *C*, age 22, is in graduate school and has $5,000 dividend income and $2,000 ordinary income from an S corporation, plus $10,000 earned income from summer work and from helping his parents with computer work in their business. His total support is $18,000. In May 2012, *C*'s parents give him stock worth $26,000, with a basis of $6,000 and a holding period of at least one year. He has a standard deduction and personal exemption that puts his 2012 taxable income in the first two tax brackets. Assuming that *C* sells the gifted stock in 2012, he will pay no tax (0% tax rate) on the $20,000 capital gain and the $5,000 dividend income, for a tax savings over his parents' hypothetical tax on the dividend and capital gains of $3,750 ($25,000 × 15%).

> ***Example 3**:* The taxable income limit for the first two brackets in 2012 for a retired married couple is $70,700. Couple *B* take a required minimum pension distribution (RMD) and invest primarily in tax-exempt bonds whose interest they are living off. Their S corporation Schedule K-1 shows ordinary income of $40,000, and they receive distributions of $50,000 during the year. They have itemized deductions of $30,000. Their net ordinary income is $10,000 ($40,000 – $30,000). Therefore, if they recognized $200,000 in capital gains or dividend income through the S corporation or otherwise, $60,700 of the gain would be subject to a zero tax rate. The other $139,300 would be subject to the normal 15% tax rate. This results in a federal tax savings of $9,105.

IC-DISC Tax Rate Arbitrage

Most practitioners are aware in the right situation (investment interest expense being less than net investment income) of the tax planning opportunity of increasing investment interest expense and investing in dividend-paying stocks to play the tax rate differential. Less well known is using interest charge domestic international sales corporation (IC-DISC) status to achieve the same results for companies that produce products in the United States but sell them overseas.

The IRS *Statistics of Income Bulletin* (Winter 2010) shows a 266% increase in the number of IC-DISCs from 2004 (425 taxpayers) to 2006 (1,209 taxpayers), and gross export receipts increased from $5.3 million to $19.3 million in that time frame. Considering that there are more than 4 million S corporations, there is obviously a very small percentage taking advantage of these provisions. Essentially the IC-DISC receives a commission based on the greater of 50% of net export income or 4% of gross revenue. Dividends to shareholders are qualified for the Sec. 1(h) 15% tax rate, and the producing entity corporation gets a deduction at 35%. To sweeten the deal, the producing entity can use Sec. 199 as well.[63]

Upcoming Net Investment Income Taxes

The Health Care and Education Reconciliation Act of 2010[64] imposes a net investment income tax of 3.8% of the lower of net investment income or modified AGI over a base amount[65] for tax years beginning in 2013. The key term is “net investment income” and how it is defined relative to S corporations. If the passthrough entity has investment income such as interest income, dividend income, certain royalties and rents, as well as capital gains, that will be part of net investment income. If the investor is considered not materially participating under the rules of Sec. 469, then the income reported on line 1 of Schedule K-1 will be considered net investment income. The S shareholder should note that estimated taxes are required for this Sec. 1411 tax. In addition, there is also a hospital insurance tax[66] scheduled to apply beginning in 2013 that would impose a 0.9% tax on wages and self-employment income above the thresholds described in Sec. 1411.

Employee Stock Ownership Plans

To facilitate the generation of cash in a tax-free manner, a C corporation might form an employee stock ownership plan (ESOP) and sell at least 30% of the stock to the trust using Sec. 1042. As long as the sellers reinvested the proceeds in publicly traded stock and bonds, the realized gain on the sale to the ESOP would not be recognized. The buyers then might convert the C to an S corporation where the income allocated to the ESOP would not be taxable.

However, there are some fairly complicated provisions designed to prevent abuses of these very favorable rules. In particular, be aware of the normal fiduciary rules that apply to trusts as well as the Sec. 409(p) disqualified person rules when dealing with S corporations. It is important to note that the corporation should set up the ESOP before it elects to be an S corporation.

Love[67] involved those issues. In this case, owners of McDonald’s franchises incorporated a management company and an operating company as S corporations. Over time they implemented an ESOP for the owners as well as 275 employees. For various reasons, including a deferred compensation plan, the benefits of the ESOP for the company’s employees were not being realized and, upon termination of the trust and an election to close the books on the date of the change in ownership, a loss inured to the individual owners. The court held that Sec. 269 did not apply and that Sec. 409(p) was not violated.

Footnotes

[1] IRS Letter Rulings 201227004 (7/6/12); 201222034 (5/18/12); and 201216030 (4/20/12).

[2] IRS Letter Rulings 201225001 (6/22/12); 201213009 (3/30/12); and 201144012 (11/4/11).

[3] IRS Letter Rulings 201225006 (6/22/12); 201218005 (5/4/12); and

201208022 (2/24/12).

[4] IRS Letter Rulings 201217010 (4/27/12); 201211007 (3/16/12); and 201146001 (11/18/11).

[5] IRS Letter Rulings 201224014 (6/15/12) and 201201006 (1/6/12).

[6] IRS Letter Rulings 201151004 (12/23/11) and 201144018 (11/4/11).

[7] IRS Letter Rulings 201223007 (6/8/12); 201222032 (5/18/12); and 201208023 (2/24/11).

[8] *Taproot Admin. Servs. Inc.*, 679 F.3d 1109 (9th Cir. 2012), aff'g 133 T.C. 202 (2009).

[9] IRS Letter Rulings 201221006 (5/25/12) and 201202002 (1/13/12).

[10] IRS Letter Rulings 201203002 (1/20/12) and 201145002 (11/10/11).

[11] IRS Letter Ruling 201202003 (1/13/12).

[12] IRS Letter Ruling 201145001 (11/10/11).

[13] IRS Letter Ruling 201150024 (12/16/11).

[14] IRS Letter Rulings 201225005 (6/22/12); 201216025 (4/20/12); and 201208013 (2/24/12).

[15] *Santa Clara Valley Housing Group, Inc.*, No. 08-cv-05097 (N.D. Cal. 1/18/12 and 9/21/11).

[16] For an in-depth look at this case, see Orbach, "*Santa Clara Valley Housing Group:* An S Corporation Abusive Tax Shelter," 43 *The Tax Adviser* 610 (September 2012).

[17] IRS Letter Rulings 201214001 (4/16/12) and 201201009 (1/6/12).

[18] IRS Letter Ruling 201218004 (5/4/12).

[19] IRS Letter Ruling 201216034 (4/20/12).

[20] IRS Letter Rulings 201220024 (5/18/12) and 201150030 (12/16/11).

[21] *In re Kenrob Information Tech. Solutions, Inc.*, No. 09-19660-RGM (Bankr. E.D. Va. 7/10/12).

[22] IRS Letter Ruling 201221008 (5/25/12).

[23] IRS Letter Rulings 201226013 (6/29/12) and 201222003 (6/1/12).

[24] If a change in basis occurs in December, the due date for reporting will be Jan. 15 of the next year.

[25] The Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142, §9(a).

[26] *Ensync Technologies*, T.C. Summ. 2012-55.

[27] *Dickerson*, T.C. Memo. 2012-60.

[28] *Penland*, T.C. Memo. 2011-274.

[29] *Garavaglia*, T.C. Memo. 2011-228.

[30] *Rogers*, T.C. Memo. 2011-277.

[31] *D'Errico*, T.C. Memo. 2012-149.

[32] *David E. Watson, P.C.*, 714 F. Supp. 2d 954 (S.D. Iowa 2010).

[33] *Joseph Radtke, S.C.*, 712 F. Supp. 143 (E.D. Wis. 1989).

[34] *Spicer Accounting, Inc.*, 918 F.2d 90 (9th Cir. 1990).

[35] *Joseph M. Grey Public Accountant, P.C.*, 119 T.C. 121 (2002).

[36] *David E. Watson, P.C.*, 668 F.3d 1008 (8th Cir. 2012).

[37] *Donald G. Cave Prof. Law Corp.*, T.C. Memo. 2011-48.

[38] *Donald G. Cave Prof. Law Corp.*, No. 11-60390 (5th Cir. 3/22/12).

[39] *Trugman*, 138 T.C. 22 (2012).

40 REG-134042-07, 77 *Fed. Reg.* 34884 (6/12/12).

41 Rev. Rul. 81-187, 1981-2 C.B. 167.

42 *Welch*, T.C. Memo 2012-179.

43 *Maguire*, T.C. Memo 2012-160.

44 *Barnes*, T.C. Memo 2012-80.

45 *Broz*, 137 T.C. 46 (2011).

46 Small Business Jobs Act of 2010, P.L. 111-240.

47 Joint Committee on Taxation, *Technical Explanation of the Tax Provisions in Senate Amendment 4594 to H.R. 5297, The Small Business Jobs Act Of 2010* (JCX-47-10), p. 6, n. 20 (Sept. 16, 2010).

48 IRS Letter Ruling 201150023 (12/16/11).

49 *Anschutz Co.*, 664 F.3d 313 (10th Cir. 2011).

50 IRS Letter Rulings 201144002 (11/4/11) and 201144003 (11/4/11).

51 IRS Letter Ruling 201126023 (7/1/11).

52 CCA 201206014 (2/10/12).

53 IRS Letter Ruling 201219003 (5/11/12).

54 *Recovery Group, Inc.*, 652 F.3d 122 (1st Cir. 2011).

55 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312.

56 Middle Class Tax Relief and Job Creation Act of 2012, P.L. 112-96.

57 Sec. 179(b); Rev. Proc. 2011-52, 2011-45 I.R.B. 701.

58 Sec. 179(f).

59 Sec. 179(f)(4)(C).

60 Patient Protection and Affordable Care Act of 2010, P.L. 111-148.

61 T.D. 9596.

62 This assumes that the children ages 19–23 are not married. If they are, then the new expanded kiddie tax will not apply.

63 For more on IC-DISCs, see Tax Clinic.

64 Health Care and Education Reconciliation Act of 2010, P.L. 111-152, §1411.

65 The base amount for married filing jointly is $250,000; married filing separately is half of married filing jointly ($125,000); single $200,000; and trusts about $12,000.

66 Secs. 1401(b)(2) and 3101(b)(2).

67 *Love*, T.C. Memo. 2012-166.

EditorNotes

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