BUSINESS ENTITY ISSUES

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INTRODUCTION

This chapter focuses on corporate tax issues that affect C corporations, S corporations, or both types of corporations.

Whether compensation paid to the owners of a closely held corporation is reasonable is a perennial IRS audit issue that is discussed in Issue 1. Practitioners preparing returns for S corporation shareholders must be aware of the stock-basis and debt-basis rules before deducting losses; these are explained in Issue 2. Issue 3 reviews concerns about the timing and character of shareholder losses when a corporation goes out of business, and Issue 4 looks at liability relief when an entire business entity is sold. The different tax effects of a real estate purchase by a corporation and by one or more of its shareholders are explored in Issue 5. Finally, Issue 6 reviews Schedules M-1, M-2, and M-3 for Form 1120, U.S. Corporation Income Tax Return.

ISSUE 1: REASONABLE COMPENSATION

The relationships between closely held businesses and their owners place compensation arrangements under special scrutiny from the IRS. In some cases, the IRS claims the compensation is excessive. In others, the IRS argues that the compensation is insufficient.

A lack of arm's-length negotiations in closely held businesses makes it difficult to separate the value of the services provided by owners and their families from the profits of the businesses. There are numerous court cases dealing with compensation in closely held businesses. When the IRS asserts that compensation is excessive, its objective is to limit the business's deduction for the compensation. There are two contexts in which this is an issue:

1. The business is a C corporation that the IRS believes is attempting to mask dividends as deductible payments to a controlling shareholder.
2. The business is any entity, and the IRS believes that it is attempting to shift taxable income to family members.

Typically, the reverse situation–insufficient compensation, with the IRS attempting to increase the amount that was reported as compensation–involves one of the following two scenarios:

1. A family member is using a partnership or S corporation to shift income to lower-bracket persons (typically children).
2. A shareholder-employee in an S corporation is attempting to avoid FICA tax by characterizing compensation as a distribution from the corporation.

There has been little litigation on the first insufficient compensation problem, but extensive litigation on the second.

Excessive Compensation

I.R.C. § 162(a)(1) allows a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." Because no statute can define what is reasonable under all circumstances, this matter is subject to challenge by the IRS. Challenges are rare when the level of compensation is determined by an arm's-length agreement. Even the extremely high pay of some athletes is usually not challenged by the IRS because these contracts are carefully negotiated in a competitive marketplace.

An IRS challenge to reasonable compensation usually occurs when one person is both the payer and the recipient, as with payments to a controlling shareholder of a C corporation.

When the IRS reduces a C corporation's deduction for compensation paid to a shareholder-employee, the excess compensation is usually treated as a dividend. Under current law, qualified dividends are taxed at the same rates as capital gains, so the consequences of recharacterizing a payment as a dividend may not be too severe even with double taxation (that is, taxation of the income to both the corporation and the shareholder). However, the IRS has the option of merely disallowing the corporation's deduction and not changing the character of the income reported by the shareholder-employee.

Factors in Determining Reasonable Compensation

The amount of reasonable compensation is inherently subjective, and there has been substantial litigation on this issue. A frequently cited case is *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949). It lists the following 11 factors that may be used to assess the reasonableness of compensation:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size of the business
4. The complexities of the business
5. A comparison of the salaries with the employer's gross income and net income

6. The prevailing general condition of the economy
7. A comparison of the salaries paid with dividends paid to the shareholders
8. The salaries paid for similar positions in similar businesses
9. The salary policy of the corporation with respect to its employees (especially its officers)
10. Compensation paid to the employee in previous years
11. Approval by the board of directors

Prior-year compensation may be important for a shareholder-employee who took little or no pay during a business's formative years when it was not profitable. Approval by the board may not be very helpful in a one-shareholder corporation.

The IRS addressed the seventh factor—salary and dividend comparison—in Rev. Rul. 79-8, 1979-1 C.B. 92. The ruling states that although the failure of a closely held corporation to pay more than an insubstantial portion of its earnings as dividends is a very significant factor, the IRS will not deny deductions for reasonable compensation paid to shareholder-employees on the sole ground that the corporation's dividend payments have been an insubstantial portion of its earnings.

Independent Investor Test

In addition to the Mayson Manufacturing factors, courts use an *independent investor* test as an overview. This test determines the level of return that would satisfy a hypothetical independent investor for the company in question. It includes detailed calculations to value the business, determine the cost of capital, and calculate the return on the hypothetical valuation.

If the return exceeds the deemed cost of capital, the analysis indicates that the shareholder-employee is a competent executive and is probably worth the payment. If the income is less than the cost of capital, or it does not meet the hypothetical expectations of the hypothetical investor, it appears that the owner is exploiting the company for excessive compensation.

Obviously, this analysis requires an expert witness to value the business and to evaluate an appropriate level of compensation. Some cases that discuss this concept include *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987); *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d Cir. 1998); and *Brewer Quality Homes, Inc. v. Commissioner*, T.C. Memo. 2003-200.

The *Mayson Manufacturing* factors and the independent investor test are theoretical concepts. However, the question faced in each case is factual in nature. Thus, the tests are useful concepts in structuring an argument and provide a framework for presenting the evidence. Because each case is unique, it is difficult to generalize or to develop any universally useful formula for determining reasonable compensation of an executive in a closely held business.

Keys to Winning Case

Taxpayers who have achieved success generally have relied on some or all of the following factors:

- A written compensation policy approved by the company's board of directors that documents the rationale for the compensation
- Compensation that does not fluctuate with the company's earnings
- A bonus system that is tied to a measure of the business's performance (such as sales or cost control) other than net earnings
- A consistent (even if nominal) dividend history, to develop a historical return on equity
- Compensation of shareholder-employees that is not in the same ratio as stock ownership
- The shareholder-employee's special training and experience
- High compensation paid by other employers or to non-owners for similar services
- Evidence that the shareholder-employee left a lucrative position to take his or her present one

Practitioner Note Facts and Circumstances Are Determinative

The IRS treats each excessive compensation case as unique, so that no one factor is solely determinative of reasonableness. The IRS and the courts consider the weight of the evidence using the factors that are present in a given situation. At a minimum, a company should consistently and timely report its payments to members. A recharacterization of a payment as compensation shortly after the IRS notifies the company that its income tax return is to be examined is less persuasive than employment contracts that predate the transactions. Consistent indicia of true employer-employee relationships are critical, especially when they are absent. A challenge is also more likely when a business is capital-intensive and when compensation is adjusted annually to match each year's profits and zero out the company's taxable income.

Catch-up Payments

Taxpayers have successfully defended high compensation payments made in later tax years if they were able to show that they were underpaid in earlier tax years. This argument has worked even where the compensation was contingent on corporate profits [*H&A International Jewelry, Ltd. v. Commissioner*, T.C. Memo. 1997-467].

This argument is particularly strong if the payments were made pursuant to a written contract entered into prior to performance of the services. Contemporaneous documentation that a shareholder-employee is underpaid when the corporation's earnings are low (e.g., when the corporation is in its formative years or the industry is in a recession) is essential for this strategy to work.

Repayment Agreements

A technique that once found favor among some practitioners was an agreement between a corporation and its employees that the employee must return any compensation that the IRS found to be excessive. The provision is known as an *Oswald clause*, from *Oswald v. Commissioner*, 49 T.C. 645 (1968). In *Oswald*, the corporation's bylaws required employees to repay excessive compensation. The Tax Court allowed the employee to deduct the amount he repaid to the corporation.

The usefulness of this technique must be questioned for two reasons:

- The presence of such an agreement suggests that the corporation anticipates paying unreasonable compensation and may be self-defeating. The IRS has used these agreements as evidence that the corporation had pre-existing knowledge that compensation paid was not reasonable.
- The benefit of this strategy may be severely limited because an employee's business expenses are miscellaneous itemized deductions, and the 2%–of–adjusted gross income (AGI) floor for these deductions may reduce or eliminate the deduction.

If a repayment of excess compensation is not required by an express employment agreement or the corporate bylaws, the employee may not be allowed to deduct the repayment [*Pahl v. Commissioner*, 67 T.C. 286 (1967)].

Compensation Paid to Non-owners

Sometimes a tax avoidance strategy involves shifting income to another family member through employment. Payments to young children are especially susceptible to excessive compensation issues. Cases in which the IRS disallowed excessive compensation to family members of shareholders include *Westbrook v. Commissioner*, T.C. Memo. 1993-634; and *Carlins v. Commissioner,* T.C. Memo. 1988-79.

Insufficient Compensation

The IRS may also assert that the compensation claimed by a taxpayer is insufficient. When taxpayers attempt to assign earned income to another person or entity, the IRS has been successful in reassigning the income to the person whose services gave rise to the earnings. An early Supreme Court case held that the person who earned income was required to include all of it in his own gross income even though he and his wife had a valid contractual arrangement assigning one-half of the income to her [*Lucas v. Earl*, 281 U.S. 111 (1930)].

Anti-abuse Provisions

I.R.C. §§ 704(e) and 1366(e) seek to prevent the use of partnerships and S corporations to assign income. Abuse can occur if a family member gives interests in a flow-through entity to children or other individuals with low tax brackets, takes minimal or no compensation for conducting the business, and thus shifts business profits to the other persons.

I.R.C. § 704(e) addresses the problem for a partnership when one family member has given or sold equity interests to other family members. If a partnership interest is created by gift or purchase from a family member, the IRS may reallocate distributive shares if the donor (or the seller who is treated as a donor for this purpose) does not first receive reasonable compensation for the services he or she rendered to the partnership. I.R.C. § 1366(e) provides that the IRS may reallocate an S corporation's income among family-member shareholders if a family member who provides services or capital to an S corporation does not receive reasonable compensation.

The IRS has been successful in reallocating income to one family member when the services performed by that person were substantial and undercompensated [*Fundenberger v. Commissioner*, T.C. Memo. 1980-113]. However, the mere fact that there is a family S corporation does not give the IRS power to reallocate income to a family member who has performed only minimal services [*Davis v. Commissioner*, 64 T.C. 1034 (1975)].

The IRS can also reallocate income when there is a family S corporation and services are performed by a person or entity also under control of the family [Treas. Reg. § 1.1366-3(a)]. There has been little litigation on this issue.

Example 13.1 Reallocation of S Corporation Income

Fabian Frankie owns all of the stock of Frankie, PC, CPA, a professional corporation that provides CPA services in Indiana. Fabian also formed another corporation, Service, Inc., that provides computerized bookkeeping and payroll products for clients. Because Service, Inc. shareholders do not need to be licensed to practice in any profession, Fabian gave substantially all of his shares in Service, Inc. to his children, Johnnie and Nellie. Frankie, PC is a C corporation, and Service, Inc. is an S corporation.

Fabian does not work directly for Service, Inc. However, Frankie, PC provides most of the management services for Service, Inc., including solicitation of clients, billing, and other client relation matters.

Prop. Treas. Reg. § 1.1366-3(a) authorizes the IRS to allocate some Service, Inc. income to Frankie, PC if Frankie, PC is undercompensated for the work it performs for Service, Inc.

S Corporation Shareholders

If an S corporation distributes profits but pays its shareholder-employees no salaries, the distributions are treated as disguised compensation and the corporation is responsible for employment taxes [Rev. Rul. 74-44, 1974-1 C.B. 287]. The IRS has won every court case involving shareholders who attempted to receive distributions in lieu of salary payments. The courts have not even compromised on the amount of taxes, interest and penalties levied by the IRS. Significant cases in this area include:

- *Radtke v. United States*, 712 F.Supp. 143 (E.D. Wis. 1989), *aff'd* 895 F.2d 1196 (7th Cir. 1990)
- *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1991)
- *Esser P.C. v. United States*, 750 F.Supp. 421 (D. Ariz. 1990)

Radtke and Esser were lawyers, and Spicer was a licensed public accountant, proving that persons in professions related to tax practice are not immune from successful IRS challenges to their compensation arrangements.

Watson v. United States

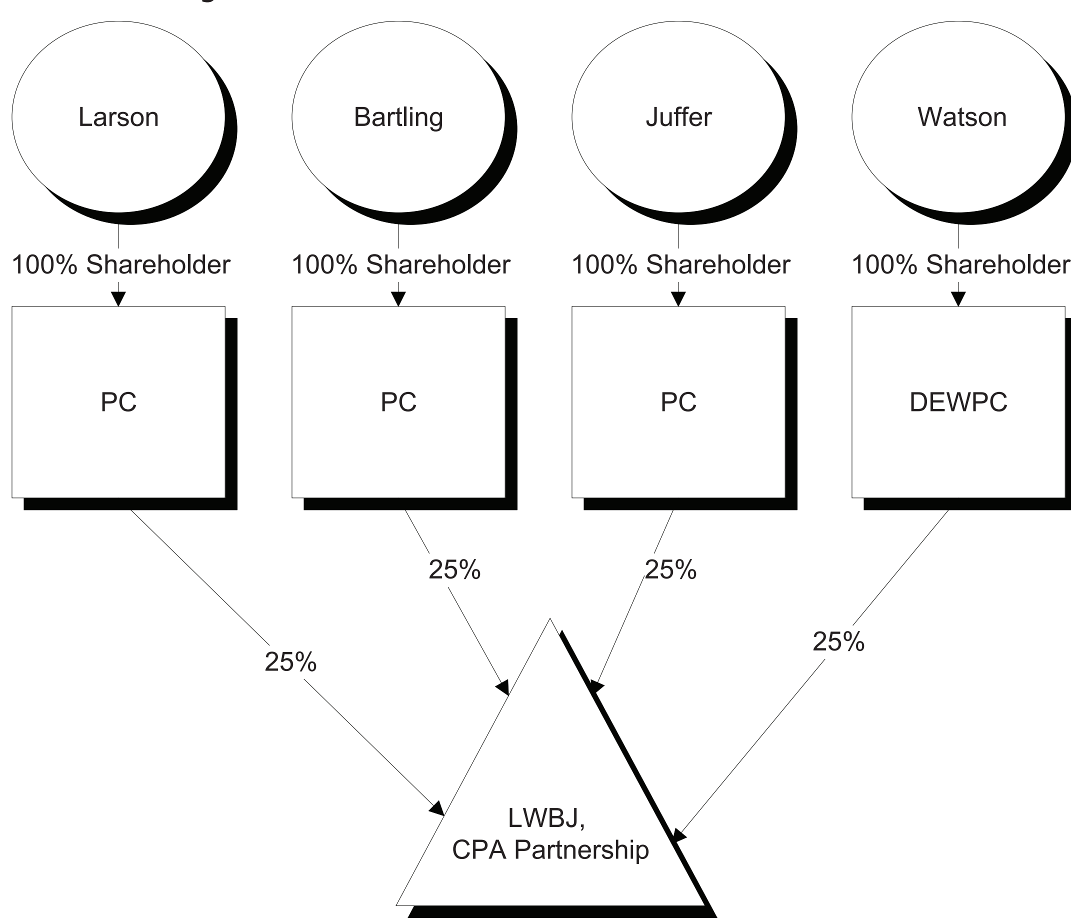
A more recent case with a similar theme [*Watson v. United States*, 757 F.Supp.2d 877 (S.D. Iowa 2010)] involved David Watson, a CPA with considerable experience in business taxation who formed a CPA firm with three associates. After several years of operating in the traditional partnership form, each partner formed a professional corporation (PC) and contributed his interest in the partnership to the PC. Each partner was the sole shareholder in his PC.

Practitioner Note Blocker Corporations

Such corporations, whose sole function is to hold interests in professional practices, are often called *blocker corporations* because their purpose is to block self-employment income.

The structure of the practice in 2002–2003 (the years concerned in the case) is shown in Figure 13.1. Because none of the other three CPAs or their PCs were involved in the case, the remainder of this discussion is confined to Watson and his PC (DEWPC), an S corporation.

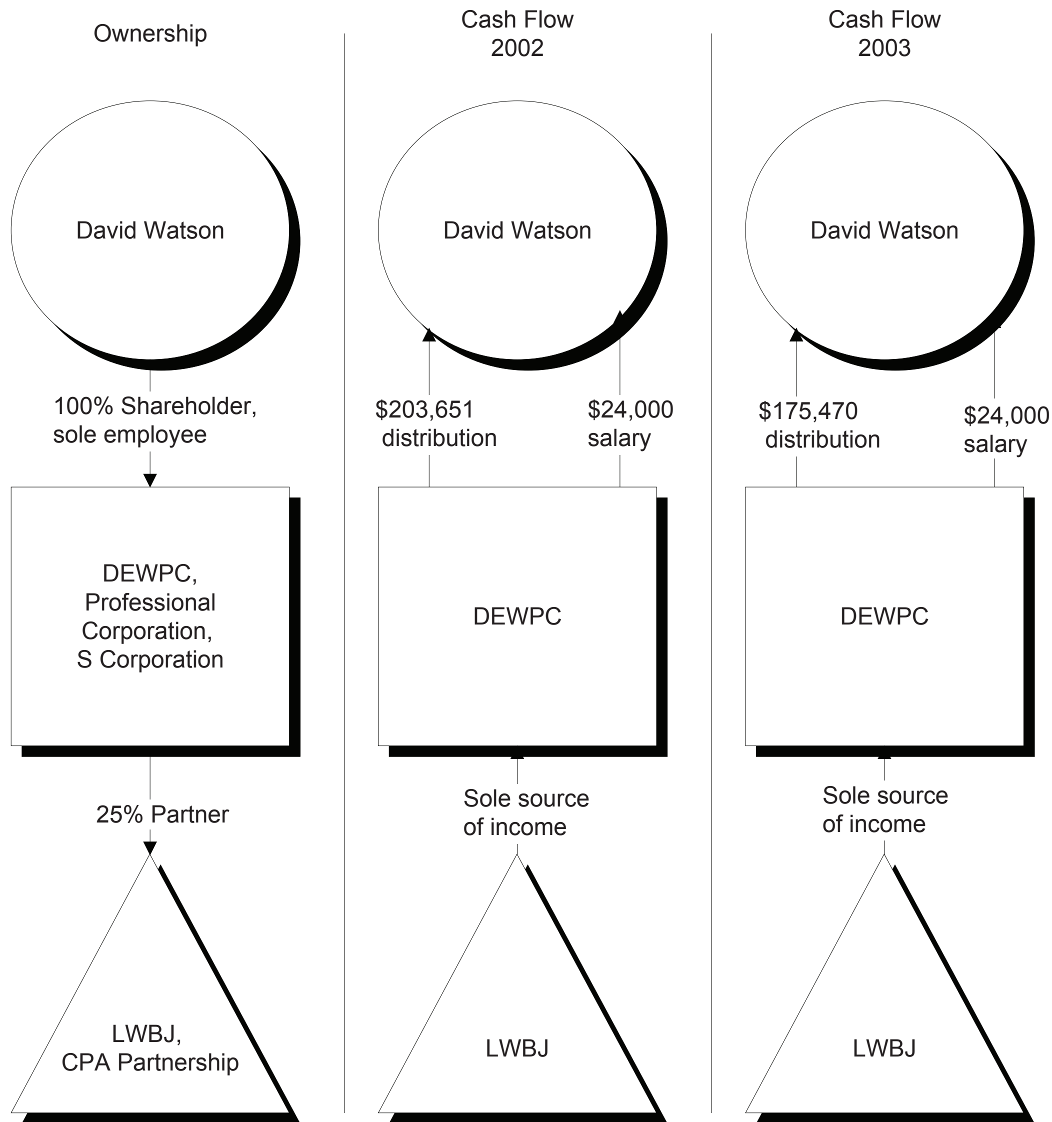
Figure 13.1 Structure of CPA Practice in Watson Case



DEWPC was properly recognized as a separate entity for federal tax purposes. Watson was its sole shareholder and sole employee. He was not personally a partner or employee of LWBJ; rather, he provided accounting services exclusively to LWBJ and its clients as an employee of DEWPC. DEWPC received no income from any source other than LWBJ, and Watson received no compensation directly from LWBJ.

Watson's salary from DEWPC was $24,000 per year. However, this was only a minor portion of his total remuneration. As the diagram in Figure 13.2 indicates, he withdrew $203,651 in 2002 and $175,000 in 2003. The case does not indicate the total amount LWBJ distributed to DEWPC in either year, but DEWPC had no other source of income and no other employee or shareholder, so the salary and distributions DEWPC paid to Watson must have been close to the total amount that DEWPC received from LWBJ.

Figure 13.2 Watson's Compensation and Distributions from the S Corporation



When the IRS examined the situation, it recharacterized some, but not all, of the DEWPC distributions as compensation. Based on compensation studies and an expert witness's testimony, the court agreed with the IRS's contention that $91,044 was reasonable compensation for Watson in each year. Thus, the court agreed that an additional $67,044 per year should be subject to FICA taxes.

Practitioner Note Adverse Effects of Low Salary

In contending that DEWPC opted to pay Watson $24,000 annually for "legitimate business reasons, and not for the purposes of reducing employment tax liability," Watson testified that there were adverse effects of setting a low salary, including lesser 401(k) contributions. But the court said it was "convinced that DEWPC structured Watson's salary and dividend payments in an effort to avoid federal employment taxes, with full knowledge that dividends paid to Watson were actually remuneration for services performed."

Observation No More Than the Law Demands

In an earlier motion for summary judgment, *Watson, PC v. United States*, 714 F.Supp.2d 954 (S.D. Iowa 2010), the taxpayer cited Judge Learned Hand's 1947 dissenting opinion in *Commissioner v. Newman*, 159 F.2d 848 (2d Cir. 1947):

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as law as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

The *Watson* court stated that it agreed fully with Judge Hand but reminded Watson of Justice Oliver Wendell Holmes's statement in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87 (1927):

> "Taxes are what we pay for civilized society."

The *Watson* court also cited a 1983 Tax Court case that quoted part of the *Hatfield v. Commissioner*, 68 T.C. 895 (1977), opinion: "The greatness of our nation is in no small part due to the willingness of our citizens to honestly and fairly participate in our tax collection system." (The *Hatfield* opinion also noted that "many citizens may dislike paying their fair share of taxes; everyone feels that he or she needs the money more than the government.")

In denying summary judgment to Watson, PC and proceeding to a trial to determine whether the taxpayer's compensation was reasonable, the district court explained that although a taxpayer "is free to structure its financial affairs in such a way as to avoid paying 'more than the law demands,' [it] is not free to structure its financial affairs in a way that avoids paying those taxes demanded by the law."

The Grey Cases

A series of cases from 2001 to 2004 illustrates how one public accountant led his clients (and his own incorporated practice) to fight losing battles to avoid FICA and FUTA taxes by taking no salaries. Joseph M. Grey prepared returns for S corporations that paid no salary to their sole shareholder-employees. (The shareholders did take distributions.) His clients, whose incomes ranged from less than $20,000 to more than $300,000, all lost their Tax Court cases.

In his own practice, Grey issued himself a Form 1099-MISC for small amounts that he reported as self-employment income. He also used the corporation's checking account as if it were his own, taking cash out as the need arose. The IRS reclassified Grey's own earnings (in excess of $37,000 per year) as FICA wages, and denied relief under Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, because there was no reasonable basis for not treating Grey as an employee and because a corporate officer is statutorily an employee [*Joseph M. Grey, PC v. Commissioner*, 119 T.C. 121 (2002)].

Practitioner Note Section 530 Relief Criteria

Section 530 of the Revenue Act of 1978 affords relief from employment tax liability when the IRS determines that workers should be classified as employees if three requirements are satisfied:

1. The business has not treated the individual (or any individual holding a substantially similar position) as an employee for any period.
2. The business has consistently treated the individual as not being an employee on all tax returns for periods after December 31, 1978. (This includes a requirement for reporting nonemployee compensation on Form 1099-MISC, Miscellaneous Income.)
3. The business has a reasonable basis for not treating the individual as an employee.

Safe havens to establish a reasonable basis include reliance on any of the following justifications for not treating the worker as an employee:

- Judicial precedent, published rulings, IRS technical advice with respect to the taxpayer, or an IRS letter ruling to the taxpayer
- A prior IRS employment tax audit of the taxpayer
- Longstanding recognized practice of a significant segment of the industry

If the Section 530 criteria are met, the business can continue to treat the employee as an independent contractor.

Figure 13.3 summarizes Grey's clientele and their failed compensation strategies. In 2002, *Grey, PC* became the third case (after the 2001 *Yeagle Drywall* and *Veterinary Surgical Consultants* cases), with seven Tax Court memorandum decisions following in 2003, including a second round for *Veterinary Surgical Consultants.* Note that most of the cases involved only moderate amounts of income. The Tax Court denied Section 530 relief in each case that requested it.

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Figure 13.3 Cases Relating to Clients of Joseph M. Grey, PC

Case Citation	Year	Schedule K-1 Income	Wages on Form W-2	Tax Preparer
Yeagle Drywall Co. v. Commissioner, T.C. Memo. 2001-284	1995 1996 1997	$26,711 $32,973 $34,509	None	Not stated in case
Veterinary Surgical Consultants, PC v. Commissioner, 117 T.C. 141 (2001)	1994 1995 1996	$83,996 $173,030 $161,483	None, but see footnote[1]	Joseph M. Grey
Joseph M. Grey, PC v. Commissioner, 119 T.C. 121 (2002)	1995 1996	$33,196 $24,990	None; Forms 1099-MISC for $6,000 (1995) and $7,000 (1996)	Joseph M. Grey, corporate president
Cohen v. Commissioner, T.C. Memo. 2003-42	1996	Two corporations; Form 1120S not filed; $289,341 total unreported income	None; $20,680 reported on Schedule C	Joseph M. Grey
Veterinary Surgical Consultants, PC v. Commissioner, T.C. Memo. 2003-48	1997 1998	$214,896 $316,484	None; Forms 1099-MISC for $26,000 (1997) and $46,000 (1998)	Joseph M. Grey
Mike J. Graham Trucking, Inc. v. Commissioner, T.C. Memo. 2003-49	1995 1996 1997	$14,262 $36,432 $25,380	None	Joseph M. Grey
Superior Proside, Inc. v. Commissioner, T.C. Memo. 2003-50	1995 1996 1997	$29,671 $29,403 $41,669	None	Joseph M. Grey
Specialty Transport & Delivery Services, Inc. v. Commissioner, T.C. Memo. 2003-51	1996 1997 1998	$15,605 $27,362 $38,487	None; Form 1099-MISC for $7,200 rent and $15,000 nonemployee compensation (1998)	Joseph M. Grey
Nu-Look Design, Inc. v. Commissioner, T.C. Memo. 2003-52	1996 1997 1998	$10,866 $14,216 $7,104	None	Joseph M. Grey
Water-Pure Systems, Inc. v. Commissioner, T.C. Memo. 2003-53	1996 1997 1998	$26,173 $17,053 $4,822	None; Form 1099-MISC for $16,500 (1997) and $20,000 (1998)	Joseph M. Grey

[1]Income reported to individual on Form 1099-MISC was diverted to his S corporation. His Form 1099 income was $125,153 in 1994, $225,469 in 1995, and $212,863 in 1996.

Statistical Approach

The IRS approach to reasonable compensation is illustrated in a 2001 Tax Court summary opinion (a small tax case). An S corporation CPA firm paid its sole shareholder and only CPA a $2,000 salary in 1994 and no salary in 1995 or 1996. However, the shareholder also received actual distributions of $56,352 in 1994, $53,257 in 1995, and $83,341 in 1996.

The IRS used a placement firm survey to determine a reasonable level of compensation and then recharacterized most (but not all) of the amounts actually distributed as wages, based on the statistical data [*Wiley L. Barron CPA, Ltd. v. Commissioner*, T.C. Summary Opinion 2001-10].

Practitioner Note Government Initiatives

Tax professionals should track the S corporation employment tax issue for future activity. In addition to the IRS's focus on compliance with the current law, legislative changes could occur.

- A Treasury Inspector General for Tax Administration (TIGTA) report decried the employment tax inequities that result from current law. It suggested that changes be made either through Treasury regulations or legislation so that a sole shareholder—or a shareholder who owns more than 50% of the S corporation's stock (including stock held by the shareholder's spouse and dependent children)—is treated like a sole proprietor [*Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations* (TIGTA Report 2005-30-080, May 20, 2005)].
- The Joint Committee on Taxation proposed to treat all of a materially participating shareholder's net income from an S corporation that is a personal-services business as net earnings from self-employment [*Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-2-05, January 27, 2005)].
- The TIGTA and Joint Committee recommendations were cited by the Government Accountability Office (GAO) in a tax gap report that included a comparison of the pros and cons of legislative options to address shareholder compensation [*Actions Needed to Address Noncompliance with S Corporation Tax Rules* (GAO-10-195, December 15, 2009)].

Summary of Compensation Issues

The clashes between taxpayers and the IRS in the area of compensation take two directions. In excessive compensation cases, the IRS tries to limit a deduction. This usually occurs in the C corporation context. The opposite problem often occurs in the S corporation arena, where shareholders are trying to limit FICA tax expense.

C corporation cases tend to be complex, involving expert witnesses who try to establish a reasonable range of compensation. S corporation cases have been much simpler, involving shareholders who perform services for the corporations but claim no, or very little, compensation.

The court decisions in excessive compensation cases are mixed, with some decided for the taxpayer, some for the IRS, and many in which the court compromises. On the other hand, the IRS has won every S corporation case where the compensation paid to the shareholder was too low.

ISSUE 2: SHAREHOLDER'S BASIS IN S CORPORATION

The two greatest areas of tax noncompliance by S corporation owners are failing to treat their own compensation as wages and deducting losses in excess of their stock and debt basis.

The S corporation remains the most popular business tax entity, in spite of its often-projected demise in favor of the limited liability company (LLC). Recent IRS data indicates that S corporations file 66% of all corporate income tax returns and 43% of all business entity income tax returns. Partnerships (including LLCs taxed as partnerships) are in second place, with 34% of the total business filings, and C corporations trail with 23% [Table 2, IRS Publication 55B, *2010 IRS Data Book*]. Thus, S corporations are high on the radar screen of those concerned with tax laws and their administration.

Quantitative and Qualitative Problems

The GAO tax gap report on S corporations [GAO-10-195, supra] discussed several problem areas. Some, such as understating income or improperly deducting personal expenses, are problems common to all tax entities and other taxpayers. Failing to treat payments to shareholder-employees as wages and deducting losses in excess of stock and debt basis are distinctly S corporation issues.

Practitioner Note High Error Rate for Tax Practitioners

The GAO report said the IRS's National Research Program found that about 68% of the 2003–2004 S corporation returns misreported at least one item, and about 80% of the time, misreporting provided a tax advantage to the corporation or shareholder.

Although 81% of S corporations used paid preparers, 71% of the returns signed by paid preparers contained errors, which was only a slight improvement over the 75% of the returns that were not signed by a paid preparer that included some type of misreporting.

Stakeholder representatives told the GAO that preparer mistakes may be due to the lack of preparer standards as well as their misunderstanding of the tax rules. Both the IRS and stakeholder representatives said that calculating and tracking basis was one of the biggest challenges for shareholders.

The failure to comply with the basis limits when deducting losses on shareholders' tax returns may be a quantitative issue or a qualitative issue:

- The *quantitative issue* deals with the interplay of income, nondeductible expenses, losses, and distributions, which are in turn affected by the corporation's accumulated adjustments account (AAA) if the corporation has any accumulated earnings and profits (E&P).
- The *qualitative issue* arises principally in the area of debt basis. Major sources of conflict about whether a shareholder has obtained debt basis include shareholder guarantees of corporate debts, back-to-back loans, and circular loans.

Congress enacted the initial version of subchapter S in 1958. The Subchapter S Revision Act of 1982 modified the rules substantially and provides the foundation for the statutes in effect for 2011. During half a century of litigation, no issue has appeared more frequently than shareholder basis.

Shareholder basis is important in the S corporation context for three principal reasons:

1. Accurate accounting is necessary to determine a shareholder's gain or loss on disposition of stock or settlement of debt.
2. Distributions from the S corporation are taxable if they exceed the shareholder's basis at the time of the distribution (although some distributions may be taxable even if they do not exceed basis).
3. A shareholder may not deduct losses passing through from the corporation in excess of the shareholder's stock and debt basis.

Although basis determines whether gain or loss is realized from the sale of any asset, determining basis for most properties does not require the complex adjustments applicable to S corporation holdings. Experienced tax practitioners will notice that similar rules apply to partners' interests in partnerships. However, although the problems are similar, the measurements of basis may be considerably different for an S corporation shareholder than for a partner.

Basis as a Loss Limit

An S corporation shareholder's basis includes basis in stock plus certain debt basis [I.R.C. § 1366(d)(1)]. A deductible loss reduces the shareholder's basis at the close of the tax year. Basis cannot be reduced below zero, but any loss that is not currently deductible because of the basis limitation is carried forward to the next tax year [I.R.C. § 1366(d)(2)]. A suspended loss does not expire: It may be deducted when the shareholder gains sufficient basis to absorb it.

Before the basis limit ever comes into play, a loss or deduction must first meet the general rules for deductibility. Thus, the deduction of an expense must not be barred as a tax deduction by public policy (such as government fines and penalties), the economic performance test

for accrual method taxpayers (if applicable), the related-party loss disallowance rules, the personal expenditure restrictions, or the limit on deducting expenses associated with tax-exempt income. Moreover, a loss or deduction must pass the hobby loss or vacation home test at the corporate level. If the corporation does not meet these tests, the loss cannot pass through to the shareholders.

Stock Basis Defined

Stock basis generally presents no particularly difficult interpretive problems. The starting point is basis at the time of acquisition, which is then adjusted each year to reflect the shareholder's distributive share of the corporation's income, deductions, and losses. Basis is also reduced by distributions received (other than dividends from E&P accumulated during tax years, if any, that the corporation was taxed as a C corporation).

Basis at Time of Acquisition

Subchapter S of the Internal Revenue Code provides a few special rules for the starting point of basis calculations. Basis in debt is reviewed later in this section, but some of these rules apply to both stock and debt basis. The key factor is how and when the stock or debt is acquired.

- If stock and debt are received in an I.R.C. § 351 incorporation, there is a substituted basis from the property that is transferred to the corporation [I.R.C. § 358].
- If the shareholder purchases the stock (and debt), the initial basis is the purchase price. This cost basis may have no relation to the book value on the corporate records [I.R.C. § 1012].
- If property is received as a gift, the initial basis calculation depends on the date of the gift, the donor's basis, and the property's fair market value (FMV) on the date of the gift [I.R.C. § 1015].
  - If the gift was made prior to 1977, the recipient's basis is the donor's basis increased by any gift tax paid, limited to FMV on the date of the gift.
  - For gifts made after 1976, the recipient's basis is the donor's basis increased by the portion of gift tax paid that is attributable to the property's appreciation in the hands of the donor.
  - If the property's FMV is less than the donor's basis, there is a special loss limit. The starting point for any loss determination is the property's FMV on the date of the gift.

Practitioner Note Actual Payment of Gift Tax Is Rare

Gift tax adjustments to stock received as a gift are rare. They apply only when the donor has exhausted his or her unified credit and actually pays a gift tax.

- If S corporation stock is received as compensation, the starting basis is its imputed cost—the gross income reported by the shareholder [Treas. Reg. § 1.83-4(b)]. This principle was applied to S corporation stock in P.L.R. 87-52-006 (September 3, 1987).
- If stock is received through an estate, the initial basis is its FMV on the date of the decedent's death or on the alternate valuation date [I.R.C. § 1014]. However, there are two important exceptions:
  - If the S corporation uses the cash method of accounting, the successor shareholder's basis must be adjusted to reflect the corporation's unrealized accounts receivable on the date of death.
  - If the prior shareholder died in 2010, the heir's initial basis depends on the executor's elections related to the estate tax. See "Stock Inherited in 2010," later in this section.

Acquisition by Inheritance

Before 1996, there were no special S corporation rules for the basis of property received from a decedent. The basis of assets inside the corporation had no bearing on the new shareholder's basis in his or her stock.

A new rule took effect for inheritances after August 20, 1996. The successor shareholder's initial basis determined under I.R.C. § 1014 is reduced by the successor shareholder's pro rata share of any asset inside the corporation that would be income in respect of a decedent (IRD)

if the heir had received the assets directly (that is, outside the corporation) [I.R.C. § 1367(b)(4)(B)].

Practitioner Note Examples of IRD

Income that a decedent had earned that had not been actually or constructively received at the time of death is not includable on the decedent's final income tax return. Such income is IRD when it is received later by the decedent's estate or a beneficiary.

The most common items of IRD are a cash-basis taxpayer's accounts receivable and deferred gains on installment receivables [I.R.C. § 691(a)]. There are corresponding deductions for cash-method payables and the estate tax that is imposed on the income items [I.R.C. § 691(b) and (c)].

The basis adjustment is a tax benefit loss from the 1996 law change, because there was no inside basis step-up for IRD items held at the corporate level under old law, and there is none after the law change. Thus, shareholders have always been required to report the corporation's taxable income on their returns.

Practitioner Note Partnership Treatment Has Similar Result

Although the tax treatments of partnerships and S corporations have similarities, there are some significant differences. One partnership provision that does not apply to S corporations is the election to adjust the basis of partnership property following the purchase of a partnership interest or the transfer of a partnership interest because of a partner's death.

I.R.C. § 754 allows a partnership to elect to adjust the successor partner's share of inside basis to correspond with the change in the new partner's outside basis. However, that basis adjustment does not apply to IRD items held by the partnership [Treas. Reg. § 1.755-1(b)(4)]. Thus, the IRD rules for successor partners and successor S corporation shareholders have similar results but result from differently structured laws.

Example 13.2 Effect of Death in 1996

Rich Blessing died in August 1996. He left his stock in LV Corporation, an S corporation, to his daughter Rebecca. The value of his stock on the date of his death was $5,500,000, including his share of the LV's accounts receivable. LV used the cash method of accounting, and it had $6,000,000 of accounts receivable on the date of Rich's death. Rich had owned one-third of the stock, so $2,000,000 ($6,000,000 ÷ 3) of the LV receivables would be IRD to Rebecca if she owned the receivables directly. The estate tax on the $2,000,000 was $800,000.

Observation Collected Receivables Still Included in Income

Whether Rich died before August 21, 1996, or after August 20, 1996, LV must report all of the accounts receivable as income when they are collected and allocate the income to the shareholders.

If LV used an interim closing at the date of Rich's death, the $2,000,000 receivable is Rebecca's income when it is collected, regardless of the date of Rich's death. If LV used a pro rata allocation of the 1996 income, it might be difficult to determine exactly when the $2,000,000 IRD was allocated to Rebecca, but as a practical matter, LV could report the first $2,000,000 of gross income allocated to Rebecca as IRD and be in substantial compliance with the new law.

Given that Rich's month of death was August 1996, it is critical to know his date of death to determine Rebecca's initial basis in her LV stock. There are two possibilities.

1. Rich died before August 21, 1996. Rebecca's initial basis in the LV stock is its $5,500,000 FMV. After the corporation collected the receivables, Rebecca's basis increased to $7,500,000 ($5,500,000 + $2,000,000 flow-through income). Rebecca cannot claim an I.R.C. § 691(c) deduction for the $800,000 portion of the estate tax paid on the $2,000,000 when she reports the income.
2. Rich died after August 20, 1996. Rebecca's initial basis in the LV stock is $3,500,000 ($5,500,000 – $2,000,000 IRD). After the corporation collects the receivables, Rebecca's basis increases to $5,500,000 ($3,500,000

+ $2,000,000 flow-through income). When Rebecca reports the $2,000,000 of IRD, she can claim an itemized deduction for the $800,000 estate tax paid on her share of the IRD. The I.R.C. § 691(c) deduction does not affect Rebecca's basis in the LV stock.

Stock Inherited in 2010

The initial basis of stock transferred from a shareholder who died in 2010 needs special scrutiny. The estate tax expired after 2009 but was to reappear in 2011. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 TRA), Pub. L. No. 111-312, reinstated the estate tax retroactively for deaths in 2010, but it allows the executor for an individual who died during 2010 to elect out of the estate tax and the fresh-start basis rules. The executor can then apply the I.R.C. § 1022 modified carryover basis rules to property included in the decedent's estate.

Cross-Reference Executor's Election for Death in 2010

See the "New Legislation" chapter of this book for a discussion of the estate tax and basis rules in effect for 2010 and later years.

As part of the estate tax repeal, new (and now repealed) I.R.C. § 1022(a)(2) provided that the basis of inherited property would be the lesser of the decedent's basis or the property's FMV on the date of death. There are some possible upward adjustments to basis:

- A $1,300,000 basis increase can be allocated among the assets in the estate.
- This limit can be increased by the amounts of the decedent's unused capital loss and net operating loss carryforwards.
- The limit is increased by the amount of the decedent's built-in losses–that is, losses that would have been allowed if the decedent's property had been sold immediately before death. This rule effectively bars assets for which losses are nondeductible, such as personal-use assets, from creating additional basis.
- The executor can allocate up to $3,000,000 in additional basis for property passing to a surviving spouse.

However, two restrictions apply when the executor allocates basis increases:

1. The basis of any IRD items cannot be increased.
2. The basis of any asset cannot be greater than its FMV on the date of death

Example 13.3 Shareholder's Death in 2010

The facts are the same as in Example 13.2, but Rich died in 2010. Rich's final adjusted basis in the LV stock he left to Rebecca is $2,500,000, including his pro rata share of LV's income, losses, and distributions in 2010.

- If Rich's executor does not elect out of the estate tax, Rebecca's initial basis in her LV stock is $3,500,000 ($5,500,000 – $2,000,000).
- If Rich's executor elects out of the estate tax, Rebecca's LV stock basis is $2,500,000 (Rich's carryover basis), but the executor can choose to increase Rebecca's stock basis by up to $1,000,000, to $3,500,000. The I.R.C. § 1367(b)(4)(B) reduction for IRD applies only if basis is determined under I.R.C. § 1014. However, an executor electing to apply I.R.C. § 1022 cannot assign additional basis to IRD items.

Practitioner Note Suspended Losses Are Not Released

There is no relaxation of the basis limit for losses that the decedent was never able to deduct because of the Subchapter S basis limits. These suspended losses are not released under either I.R.C. § 1014 or I.R.C. § 1022.

S Corporation Debt Basis

Debt basis for deducting losses is one of the most frequently litigated issues since the early days of Subchapter S. The issues being litigated can be categorized roughly into four areas:

1. Whether a shareholder's guarantee of a loan from an outside lender can create shareholder basis
2. Whether a loan via a person or entity related to the shareholder can create shareholder basis
3. Whether a circular loan—a shareholder loan to an S corporation using funds that originated with the S corporation—creates basis
4. Other issues, from trivial documentation questions to much more substantive problems

Overall, the IRS has been the big winner, at least in the first three categories. However, there have been some taxpayer victories, notably in the related-party loan area, in more recent years.

Guarantees and Similar Arrangements

A shareholder obtains debt basis by making a loan to the S corporation. The IRS and the courts have generally denied shareholders basis for corporate debt to outside creditors. Guaranteeing a loan made by a creditor to the S corporation does not increase a shareholder's basis, nor does a shareholder obtain basis from a related person or entity's loan to the corporation. The operative principle is that the shareholder must make an actual economic outlay to acquire debt basis.

Taxpayer Losses in Early Cases

One of the earliest cases was *Raynor v. Commissioner*, 50 T.C. 762 (1968), in which the court held:

> No 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 all or a part of the obligation. Prior to that crucial act, "liability" may exist, but not debt to the shareholders.

In a plethora of cases with the same issue, the Tax Court always reached the same conclusion on similar facts. *Perry v. Commissioner*, 47 T.C. 159 (1966), *aff'd* 392 F.2d 458 (8th Cir. 1968), is another frequently cited case with this issue. In one debt-basis case, the unfortunate shareholder was allowed to claim a $2.50 (no trailing zeros omitted!) deduction, but nothing further [*Harrington v. United States*, 605 F.Supp. 53 (D. Del. 1985)].

Taxpayer Victory: the Selfe decision

The result in *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) was a major departure from prior holdings. The Eleventh Circuit Court of Appeals reviewed a Northern District of Alabama U.S. District Court decision that had appeared to be so insignificant that it had not been reported. The appellate court heard a novel argument and allowed the shareholder to claim basis created by guaranteed loans. However, the facts of the case indicated that the taxpayer had made an actual economic outlay, as distinguished from the mere guarantees that defined so many of the other cases.

Selfe involved an unusual set of facts. The sole shareholder of a thinly capitalized S corporation had operated the business as a proprietorship and then incorporated it. The business liabilities arose in the proprietorship and were transferred to the corporation.

The taxpayer (appearing pro se) pointed out that in a similar case the Fifth Circuit Court of Appeals held that a loan from an outsider to a thinly capitalized C corporation was tantamount to a contribution of capital by the shareholder [*Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1972)].

The Eleventh Circuit stated that "under the principles of *Plantation Patterns*, a shareholder guarantee of a loan may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor." The court found that the facts of *Selfe* were so similar that it reversed and remanded the district court decision, telling the district court to apply *Plantation Patterns* (thus allowing the shareholder basis and a loss deduction).

Cases after Selfe

The holding in *Selfe* created a resurgence of litigation on the subject of S corporation basis. However, as of this writing, no other court has allowed a shareholder to have basis on similar facts. Several Circuits have rendered decisions conflicting with *Selfe*. [See *Leavitt v. Commissioner*, 875 F.2d 420 (4th Cir. 1989), cert. denied 493 U.S. 958 (1989); *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990); *Goatcher v. United States*, 944 F.2d 747 (10th Cir. 1991); and *Uri v. Commissioner*, 949 F.2d 371 (10th Cir. 1991).] Thus the *Selfe* case is of only limited precedential value.

Rulings Denying Debt Basis

The IRS refused to allow pass-through debt basis in Rev. Rul. 69-125, 1969-1 C.B. 207, using a fact pattern in which a partnership and an S corporation had the same owners and the partnership made a loan to the S corporation. The loan from the partnership did not constitute *indebtedness of the corporation to the shareholders* (the statutory language for debt basis), so there was no basis by attribution.

The early 1970s produced two rulings on shareholder guarantees and payments, both of which demonstrated that the IRS was unwilling to permit a liberal interpretation of debt basis.

- Rev. Rul. 70-50, 1970-1 C.B. 178, states that a shareholder's guarantee of corporate debt gives basis to the shareholder only when the shareholder actually pays all or a part of the obligation.
- Rev. Rul. 71-288, 1971-2 C.B. 319, reaffirms the position stated in Rev. Rul. 70-50. A shareholder's payment of a corporate debt in a later year does not create shareholder basis in the earlier year.

Practitioner Note Debt Basis or Equity Basis?

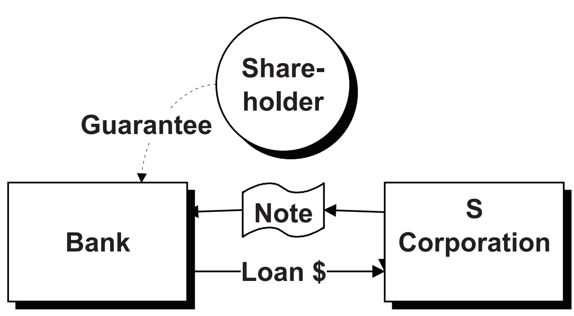
The character of the basis allowed by Rev. Rul. 70-50 is not entirely clear. Perhaps it is debt basis, but it may be equity basis. The U.S. Supreme Court has held that a shareholder's payment of a corporation's debt is essentially a substitution of creditors, so there is no new debt but merely a transfer between holders [*Putnam v. Commissioner*, 352 U.S. 82 (1956)]. A similar decision was reached in *Estate of Mixon v. Commissioner*, 464 F.2d 394 (5th Cir. 1972). However, the facts and the parties' subsequent actions may indicate that the new arrangement is a contribution to capital [*In re Lane*, 742 F.2d 1311 (11th Cir. 1984), and *Plantation Patterns*, supra].

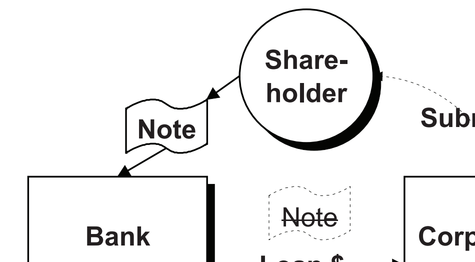
Either stock basis or debt basis will permit a loss deduction, although stock basis is reduced before debt basis. The distinction becomes more important in a subsequent year when the corporation reports income and the shareholder has a net increase in basis, because the shareholder must restore debt basis before increasing stock basis.

Basis Allowed in Substituted Debt

Rev. Rul. 75-144, 1975-1 C.B. 277, provides useful guidance for a shareholder who has guaranteed a corporation's debt and wants to create debt basis without an actual outlay of cash. It holds that a lender's acceptance of a shareholder's promissory note in substitution for the S corporation's note is a payment of the corporation's debt that constitutes an economic outlay. Under the doctrine of subrogation, the corporation's note to the bank becomes the corporation's obligation to the shareholder and thus gives the shareholder basis. Figure 13.4 illustrates the S corporation and shareholder obligations before and after the shareholder provides a personal note to the lender.

Figure 13.4 Rev. Rul. 75-144—Obligations before and after Note Replacement





In many cases the corporation has pledged its own assets to the lender as security for the note that the shareholder is willing to assume. There may be a concern that the continued securitization will jeopardize the economic outlay, but the IRS has privately ruled that the shareholders may claim basis through such an arrangement, even though the corporation's assets remain pledged as collateral [P.L.R. 87-47-013 (August 20, 1987)].

The facts in *Gilday v. Commissioner*, T.C. Memo. 1982-242, were similar to those in Rev. Rul. 75-144, except that the state law doctrine of subrogation did not cover the transaction. The Tax Court held that the shareholder had complied with the IRS's position in all material economic respects, and it allowed the loss deduction.

Loans from Related Parties

Shareholders generally have been unsuccessful in attempts to use a similar tactic to obtain basis from loans made by related parties.

Taxpayer Loss: The Underwood *Case*

Underwood v. Commissioner, 535 F.2d 309 (5th Cir. 1976), *aff'g* 63 T.C. 468 (1975), illustrates a problem that can arise when a shareholder has interests in more than one business. The shareholder (Underwood) owned two restaurants–a profitable C corporation with surplus cash and an S corporation with net operating losses.

- In 1965 and 1966, the C corporation made a series of loans to the S corporation, totaling $110,000.
- In 1967, the shareholder gave his personal demand note for $110,000 to his C corporation. The C corporation then marked the S corporation's debt paid, and the S corporation wrote a demand note to the shareholder. Both notes included a 6% interest rate, and the C corporation periodically accrued and reported as income the interest it was owed on its loan to the shareholder. No party either advanced or received any funds when the notes were exchanged.
- In 1969, the S corporation's losses exceeded the shareholder's basis in his stock, but he claimed all of the losses by relying on his basis in the substituted loan.
- In 1970, the shareholder paid the C corporation loan in full.

The courts upheld the IRS's disallowance of the loan basis because Underwood had not loaned the money directly to the S corporation. The lack of an actual, direct economic transfer from the shareholder to the corporation appears to have been fatal.

In affirming the Tax Court, the Fifth Circuit Court of Appeals held that the shareholder's reliance on Rev. Rul. 75-144 was misplaced, stating that "the factual situation in the ruling is significantly different and warrants disparate treatment. In the ruling, the obligee on the shareholder's note was an outsider, a bank, which stood ready to enforce the obligation. Hence it was clear at the time the substitution occurred that at some future date payment would be required. Here, by contrast, the obligee on the taxpayers' demand note was their own wholly-owned corporation. It was not clear from the outset that the taxpayers would ever make a demand [through the other corporation] upon themselves for payment of the note; consequently, at the time of the transaction the taxpayers had not made the requisite additional investment in their corporation."

Taxpayer Victory: The Culnen Case

There have been some notable departures from this logic. When shareholders in loss corporations have used other entities as incorporated pocketbooks, the courts have occasionally granted basis.

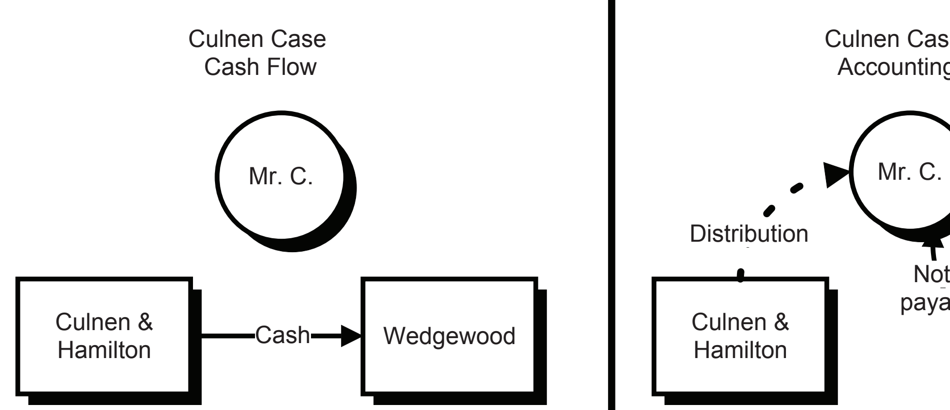
Practitioner Note Incorporated Pocketbook

The *incorporated pocketbook* concept regards the corporation as an agent for the shareholder. The corporation often pays personal and other expenses on behalf of the shareholder. The payments may be posted to the corporation's books as loans to the shareholder, creating a loan balance that the shareholder liquidates by making payments to the corporation.

The majority shareholder in Wedgewood, an unsuccessful S corporation, was also the sole shareholder of Culnen & Hamilton, a profitable corporation. The shareholder had Culnen & Hamilton pay out about $6,000,000 in 88 transactions in 1987–1990 on behalf of Wedgewood.

Some Culnen & Hamilton payments were made directly to Wedgewood, and others were paid to third parties for Wedgewood's expenses, but all of the payments were treated as loans to the shareholder on Culnen & Hamilton's books. Wedgewood's books showed the same amounts as debt owed to the shareholder, and it recorded more than $600,000 interest due to the shareholder from the loans. Figure 13.5 illustrates the cash flow and the accounting for the loans.

Figure 13.5 The Culnen Situation: Cash Flow and Accounting



The shareholder claimed losses from Wedgewood of $388,106 in 1987, $651,357 in 1989, and $213,732 in 1990. The IRS disallowed the loss deductions because of the basis limitation, contending that the shareholder had no basis in the loans because the cash flowed directly between the corporations.

At trial, the shareholder's accountant testified that Culnen & Hamilton had been an S corporation with "a lot of undistributed taxable income" and that the shareholder "felt the money that was left in Culnen & Hamilton, because it was undistributed to him, that he could spend and do what he wanted with. So, rather than write a check to himself and write a check to a third party, he would just–if he wanted to buy a company or whatever, he would just write it out–have the bookkeeper write it out of Culnen & Hamilton, charge it to his loan account, and that's the way he did business for the 20 years that I've been his accountant."

The Tax Court gave credence to the incorporated pocketbook treatment and held that the Wedgewood loans were truly loans from the shareholder that were consistently and formally treated as such by both corporations and the shareholder [*Culnen v. Commissioner*, T.C. Memo. 2000-139, *rev'd* on another issue 28 Fed.Appx. 116 (3d Cir. 2002)].

Circular Lending Arrangements

The IRS has characterized lending arrangements as circular and lacking in the requisite economic outlay when the borrowing corporation in essence provides the funds to the shareholder, who in turn lends money back to the corporation.

Although there are undoubtedly circumstances where the fact pattern does have substance, the claim for basis is dubious at best in many cases.

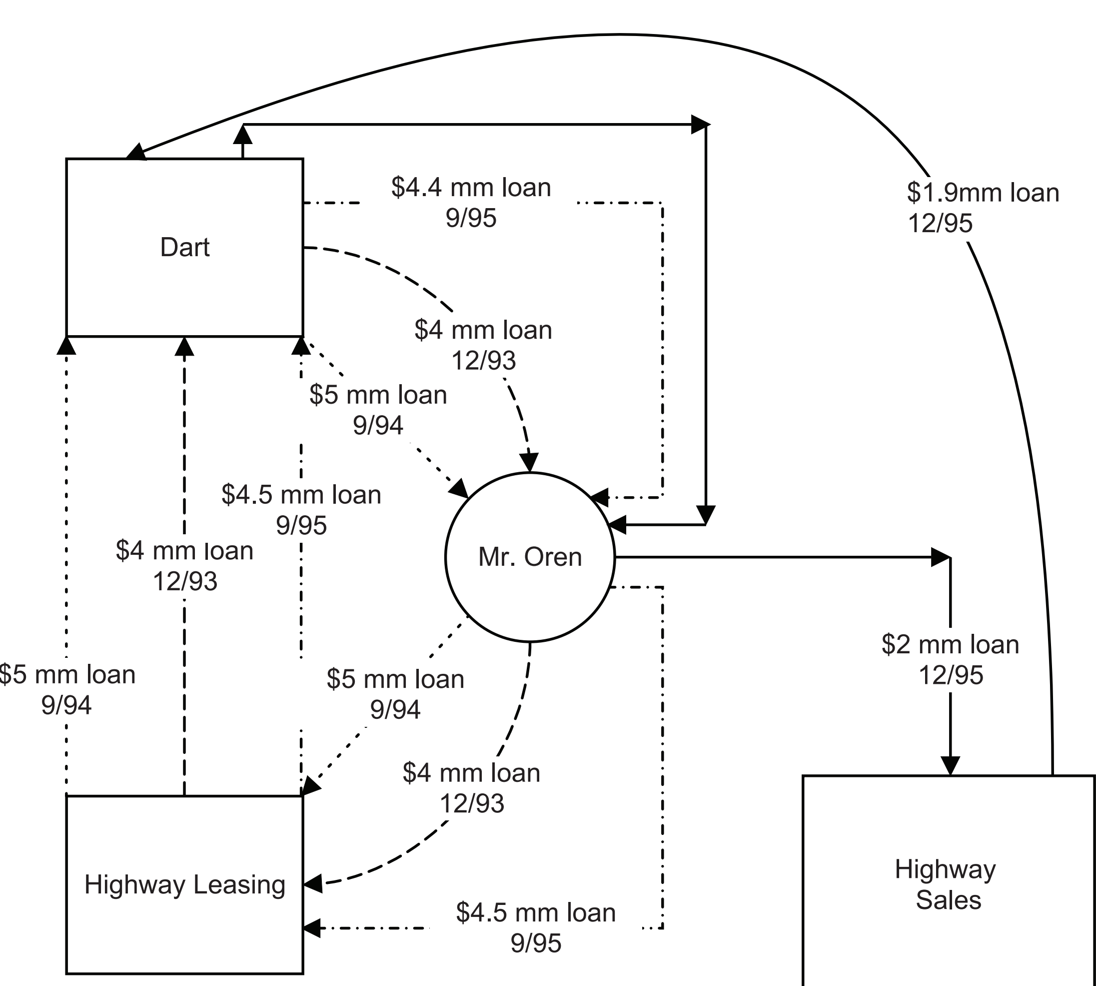
One of the more complicated and egregious cases is *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004), *aff'g* T.C. Memo. 2002-172. Oren owned three S corporations–a trucking business that contracted with independent drivers, a tractor sales business, and a trailer leasing business. Depreciation created significant tax losses for the sales and leasing businesses, although they had operating profits. To facilitate deduction of the pass-through tax losses, the shareholder and the three corporations entered into a series of loan transactions:

- The trucking business (Dart) loaned the shareholder about $15 million in three loans over 3 years.
- The shareholder loaned the sales and leasing corporations the same amounts.
- The sales and leasing corporations over time loaned the same amounts back to the trucking company.
- Each loan transaction within a cycle occurred on the same day or within a few days of each other. The terms of the loans, including a 7% annual interest rate, and repayment conditions (on demand plus 375 days), were the same in each transaction.

The shareholder tried to rely on *Gilday v. Commissioner*, supra, to validate his basis argument. However, the courts pointed out that *Gilday* involved a third-party lender, whereas Oren borrowed from and lent to organizations that he controlled. There was no feasible situation in which Oren would bear an economic loss. He was denied both basis and amount at risk for these arrangements.

Figure 13.6 illustrates the transactions in the Oren case.

Figure 13.6 Lending Arrangements in Oren Cases



Back-to-Back Loans

The IRS is often suspicious about whether economic substance exists in arrangements wherein a shareholder borrows funds and then loans them to an S corporation. These transactions are often termed back-to-back loans.

In *Seven Sixty Ranch Co. v. Kennedy* [17 A.F.T.R.2d (RIA) 587 (D. Wyo. 1966)], the S corporation's sole shareholder personally borrowed money from banks, which disbursed the funds to the S corporation. Because the shareholder deposited the loan proceeds in the corporation's bank account, the IRS challenged whether there was a debt directly from the shareholder to establish basis. In allowing the shareholder to deduct the pass-through losses, the court noted that the S corporation had properly drawn up promissory notes to the shareholder and that these notes were valid debt instruments.

The IRS did not challenge the validity of the back-to-back loans in *Cornelius v. Commissioner*, 494 F.2d 465 (5th Cir. 1974), *aff'g* 58 T.C. 417 (1972). The court noted that each yearly advance and repayment was a separate and complete transaction.

The *Seven Sixty* and *Cornelius* cases, as well as others with similar facts, appear to have had economic substance. The IRS is successful in challenging basis when the context indicates that there is little or no substance. The case of *Kaplan v. Commissioner*, T.C. Memo. 2005-218, involved back-to-back loans with slightly different twists: There was at least nominally an outside lender, and the back-to-back loans straddled the end of a tax year. The chronology was as follows:

- The sole shareholder of three S corporations borrowed $800,000 from his bank on December 29, 1997.
- The shareholder provided no personal financial statements to the bank, but he collateralized the loan with bank deposit accounts opened in the names of two of his wholly owned S corporations.
- On the same day, he issued an $800,000 check to the third corporation, which had a $792,752 tax loss for 1997.
- On the same day, the loss corporation loaned $550,000 to the first S corporation and $250,000 to the second S corporation. Both checks were immediately deposited in the newly opened bank accounts.
- On January 8, 1998, the shareholder borrowed $550,000 from the first S corporation and $250,000 from the second S corporation, depositing the checks in his own account at the bank.
- On the same day, the shareholder repaid the bank loan by issuing a check drawn on his account at the bank.

The Tax Court refused to accept the transactions as anything other than offsetting bookkeeping entries. Because there was no economic outlay on the part of the shareholder, he was denied basis.

Planning for Controlled Group

The *Oren* and *Underwood* cases illustrate the proverbial "heads I lose, tails you win" situation faced by many taxpayers with multiple business entities. One corporation produces taxable income, resulting in immediate tax liability, while the common shareholder is unable to use losses generated by another corporation.

Because separate entities may not combine their income and losses–and the shareholder may not aggregate basis–the shareholder may be tempted to combine the entities via a merger or some other transaction. However, that may not be desirable for nontax reasons. For example, in *Underwood* the shareholder most likely wanted to insulate each restaurant from possible claims against the other.

An ideal solution might be to combine the entities for tax purposes but leave them separated for nontax purposes. Several arrangements can accommodate this objective, including establishing a holding company as either a C corporation or an S corporation.

C Corporation Holding Company

Establish a holding company as a C corporation and transfer at least 80% of the stock of each operating corporation to the holding company. The parent and subsidiaries can then elect to file a consolidated income tax return [I.R.C. §§ 1501–1504 and regulations]. This strategy provides the structure for virtually all publicly traded corporations and for many closely held corporations.

The consolidated return structure has considerable complexity, and all members of the group (including the parent) must be C corporations. Therefore, it is not possible to attain flow-through entity status with this plan.

This plan allows some diversity in ownership of the individual business units, but the parent corporation and other members must hold at least 80% of the stock of each corporation. There are complications when an individual business unit joins or leaves the group.

S Corporation Holding Company

Establish a holding company as an S corporation and transfer all of the stock of each operating corporation to the holding company. The parent S corporation then elects to treat each underling as a qualified Subchapter S subsidiary (QSub). The result is that the entire group is treated as a single S corporation for federal income taxes (and most state income taxes). Several S corporation specialists describe this structure as the master S corporation setup.

Figure 13.7 shows the nontax structure of the master S corporation group, and Figure 13.8 shows the federal income tax treatment of the QSub structure.

Figure 13.7 Legal Structure of Master S Corporation and Subsidiaries

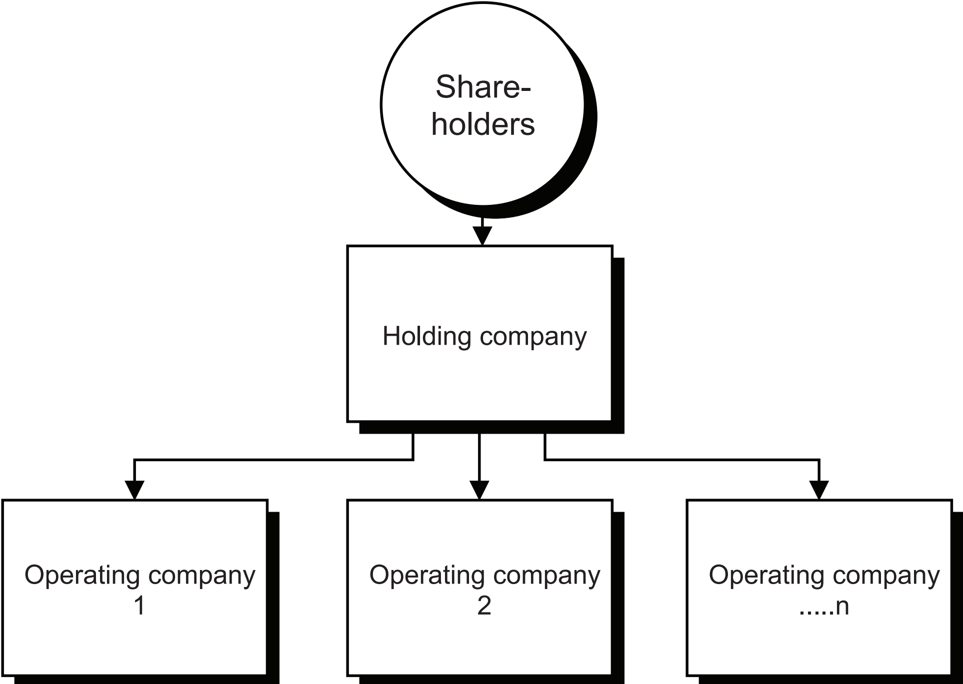
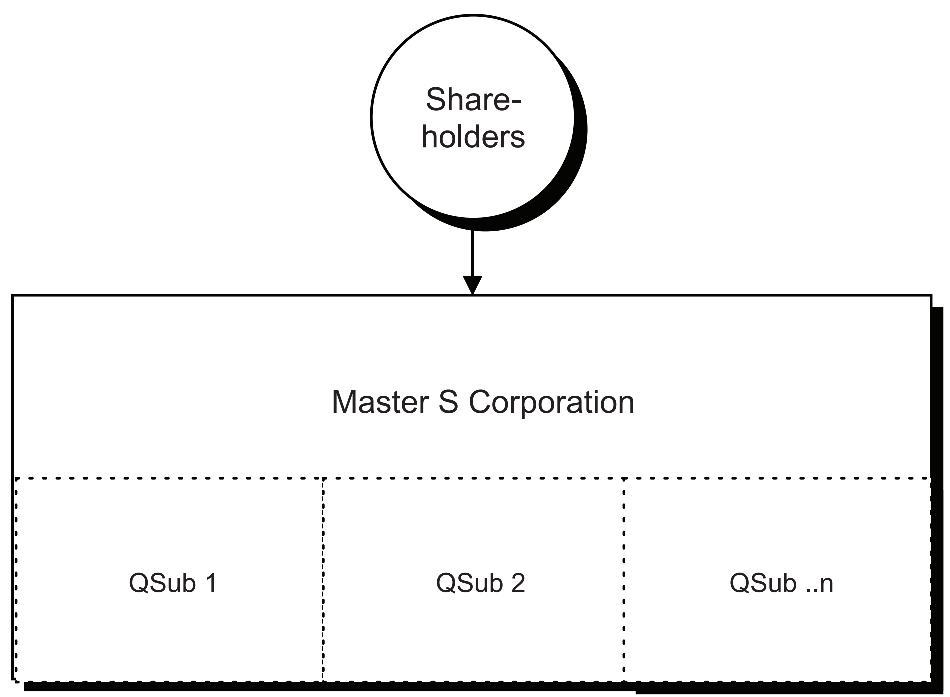


Figure 13.8 Tax Treatment of Master S Corporation and Subsidiaries



Cross-Reference Other Loss Limits

After passing the basis hurdle, the next step in deducting a loss is ascertaining that the taxpayer has a sufficient amount at risk. Finally, passive-activity loss limits must be considered. See pages 158–171 in the *2008 National Income Tax Workbook* for a further discussion of the basis and at-risk rules.

Computation of Basis Adjustments

A shareholder's basis is adjusted annually for the shareholder's allocable portion of the S corporation's income and loss items, as well as for distributions. If there is more than one shareholder during a tax year, the corporation must allocate each income or loss item on a per-day, per-share basis. An exception applies only if there is a change in ownership and the shareholders consent to split the year [Treas. Reg. § 1.1377-1].

General Order of Adjustments

For tax years beginning after 1996, distributions reduce basis before basis is reduced for losses [I.R.C. § 1367]. Adjustments to basis must be made in the following order:

1. Start with basis at the end of the prior year.
2. Add all income items, including separately stated income items and tax-exempt income.
3. Subtract distributions [other than dividends from the corporation's accumulated earnings and profits (AE&P) from C corporation years, if any] from basis until it is zero. Basis cannot be reduced to a negative number.

Practitioner Note Excess Distributions Are Capital Gain

Distributions are tax-free to the extent of the shareholder's basis. If distributions exceed basis, the excess is treated as a capital gain.

4. Subtract loss and deduction items (including separately stated deductible and nondeductible expenses), if basis remains after subtracting distributions.

Observation Effect on Taxpayer Who Has Low Basis

If a shareholder who has held the stock for more than a year has a lower basis than the total of his or her share of the losses and distributions, this ordering rule is taxpayer-friendly in that the distributions are tax-free or taxable at the lower rate for capital gains. However, it also defers deductions, because after basis is exhausted any further tax deductions are suspended until a year in which the shareholder obtains more basis via pass-through income, capital contributions, or loans to the S corporation.

The actual timing of the items during the year is disregarded.

Example 13.4 Order of Basis Adjustments

Cheryl is the sole shareholder of Cherco, an S corporation that uses the calendar year as its tax year. It was never a C corporation and has no AE&P. On January 1, Cheryl's stock basis was $120,000. Her Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., showed $150,000 of income items and $151,000 of loss items, plus $250,000 in distributions.

Figure 13.9 shows the ordering of Cheryl's distributions and flow-through income and losses. She can deduct only $20,000 of the loss items before her basis is reduced to zero. The remaining $131,000 of loss items is carried forward to the next year, when the basis limitation will be applied again.

Figure 13.9 Stock Basis Calculation

	Item	Amount
1.	Beginning basis	$120,000
2.	Income items	150,000
3.	Basis before distributions	$270,000
4.	Distributions	(250,000)
5.	Basis before losses	$ 20,000
6.	Loss items	$151,000
7.	Limit on deductions	(20,000)
8.	Suspended loss items	$131,000

Nondeductible Expenses after 1982

An S corporation's nondeductible expenses (such as premiums for key-employee insurance, the 50% reduction of meal and entertainment expenses, and so forth) are loss items that reduce shareholder basis. Shareholders may choose between a general ordering rule and an elective ordering rule for these items.

General Ordering Rule

The general ordering rule reduces basis for nondeductible items before considering potentially deductible expenses and losses [Treas. Reg. § 1.1367-1(f)].

- If the nondeductible items exceed the shareholder's adjusted basis after distributions, the shareholder's basis is reduced to zero. Nothing further can be deducted until an adjustment results in additional basis, but there is no carryforward of excess nondeductible items.
- If the nondeductible items' total does not exceed basis, the shareholder's basis is reduced by the total amount and the remaining basis is then available to allow potentially deductible losses.
- If the total of the potentially deductible losses does not exceed the remaining basis, all of the losses reduce the shareholder's basis. However, the losses are still subject to the at-risk and passive-activity loss deduction limits, if applicable, before they reduce the shareholder's taxable income.
- If the total of the potentially deductible items exceeds the remaining basis, the shareholder's basis is apportioned to them pro rata. A current-year deduction is claimed for the amounts that do not exceed basis, and the excess of each category is carried forward until the shareholder has sufficient basis.

Example 13.5 Nondeductible Items Considered First

Mary is a shareholder in Maco, an S corporation. At the beginning of the tax year, Mary's basis in her stock was $5,000. Maco sustained an ordinary loss and also incurred some meal and entertainment expenses during the year. Mary's share of the ordinary loss is $4,500, and her share of the

nondeductible portion of the meal and entertainment expense is $1,500. The corporation had no income items, and Mary received no distributions.

Under the general rule, Mary reduces her basis to $3,500 ($5,000 – $1,500) for the nondeductible meal and entertainment expenses. She then can deduct $3,500 of her share of the corporation's ordinary loss and reduce her basis to zero. She can carry the $1,000 ($4,500 – $3,500) loss that exceeds her basis forward to the next year.

Elective Ordering Rule

The elective ordering rule gives a lower priority to the nondeductible items that would reduce basis first under the general ordering rule [Treas. Reg. § 1.1367-1(g)].

- The total amount of potentially deductible items is compared to the shareholder's adjusted basis after distributions. If the total exceeds the shareholder's basis, basis is apportioned to them pro rata. A current-year deduction is claimed for amounts that do not exceed basis, and the excess in each category is carried forward until the shareholder has sufficient basis.
- If the potentially deductible items do not exceed basis, their total reduces the shareholder's basis. They are then subjected to the at-risk and passive-activity loss deduction limits, if applicable.
- Any nondeductible items then reduce the shareholder's remaining basis. If the nondeductible items do not exceed available basis, the shareholder's basis is reduced by all of these amounts.
- If the nondeductible items exceed available basis, the shareholder's basis is reduced to zero. The excess amount is carried forward to reduce the shareholder's basis whenever basis is restored.

Example 13.6 Nondeductible Items Considered Last

Under the elective rule, Mary (from Example 13.5) first reduces her $5,000 basis by her $4,500 portion of the ordinary loss. She can deduct all of the $4,500 loss in 2010, subject to the at-risk and passive-activity loss limitations. She then subtracts $500 of the nondeductible meal and entertainment expenses from her basis, reducing it to zero. She must carry the remaining $1,000 ($1,500 – $500) of nondeductible meal and entertainment expenses forward and use it to reduce basis in a future year.

Observation Carryover Required under Elective Rule

At first glance, it appears that a shareholder should always opt for the elective ordering rule because it provides more basis for deductible items. It there is a large amount of nondeductible expenses, however, the shareholder might benefit more from the general ordering rule, because it does not require nondeductible expenses to be carried forward if they exceed basis.

Example 13.7 Ordering Rules Contrasted

The facts are the same as in Examples 13.5 and 13.6, except that the nondeductible expense is $50,000 in punitive damages awarded to the other party in a lawsuit, rather than the $1,500 of nondeductible meal and entertainment expenses. Mary's share of Maco's deductible loss is $4,500, and her beginning basis is $5,000. The general rule and elective rule yield the following results:

Figure 13.10 Comparison of Ordering Rules for Nondeductible Expenses

Item	General Rule	Elective Rule
Beginning basis	$ 5,000	$ 5,000
Less nondeductible expense	(50,000)	
Basis for deductible losses	0	$ 5,000
Loss allowed in current year	0	(4,500)
Less nondeductible expense		(500)
Ending basis	$ 0	$ 0
Carryforward to next year		
Nondeductible expense	$ 0	$45,000
Ordinary loss	$ 4,500	$ 0

Figure 13.11 summarizes the two ordering rules.

Figure 13.11 Ordering Rules for Basis Adjustment

Order	General Rule		Elective Rule	
Item	**Effect on Basis**	**Carryover**	**Effect on Basis**	**Carryover**
Income	Increase	N/A	Increase	N/A
Nondividend distributions	Decrease, not below zero	N/A	Decrease, not below zero	N/A
Nondeductible expenses	Decrease, not below zero	None		
Potentially deductible expenses and losses	Decrease, not below zero	Carry forward, indefinitely	Decrease, not below zero	Carry forward, indefinitely
Nondeductible expenses			Decrease, not below zero	Carry forward, indefinitely

Summary of Basis Issues

Although mathematical computations involving basis can be tricky, the ordering rules are not the most troublesome basis problem facing S corporation shareholders. The real crux of the basis issue is the obligation for the shareholder to make an actual economic outlay. This issue can arise in connection with stock basis, but it is most problematic when determining debt basis.

Tax professionals should be on the alert for the obstacles to clients' loss deductions that may result from the IRS's hardline administrative position and its nearly universal support from the courts. The means that have been used to restructure debts to attain the desired level of shareholder basis are not necessarily consistent with typical commercial practices. Lenders may question the reasons for altering their loans to closely held corporation with shareholder guarantees. However, a shareholder is unlikely to prevail in an examination or appeal without following the revenue rulings.

ISSUE 3: SHAREHOLDER DEDUCTIONS WHEN CORPORATIONS FAIL

In times of financial stress, many closely held corporations are unable to survive. Shareholders often have substantial investments and now have no realistic hope of recovery. Therefore, they would like to claim ordinary loss deductions when the corporation fails.

There is considerable case law on these issues, but many of the cases are factual in nature and shed little light on the law per se. This material discusses a few of the more important cases but stops short of claiming to provide a bright line test or foolproof formula that an investor may use to claim an ordinary loss deduction. As with many subjective problems, the taxpayer is best served by accumulating as many factors as possible to justify the desired treatment.

Criteria for Any Deduction

An important aspect for any loss deduction is to determine whether there has been a recognition event, such as a disposition. Then the taxpayer must be able to support basis in the investment, as well as a profit motive for the obligation. If a bad debt deduction is claimed, there may be a question as to whether the funds transfer was really a loan or was in fact an equity investment. (This situation is most likely to occur when the person seeking the bad debt deduction is a shareholder in the failed corporation.)

Figure 13.12 illustratess the loss deduction possibilities–ordinary, capital, or no deduction at all–that might be available to a shareholder. This diagram should provide an overview for structuring and documentation both at the time of the initial transaction and at the time of write-down or write-off.

Practitioner Note Plan for Downside from the Outset

At the outset of a business activity, projections are rosy and everyone is friendly. However, this is the time for attorneys and accountants to become naysayers and advise clients of the downside risks. The form of transactions is often as important as their substance. The old adage "It's not what you do but how you do it" often rings true.

Qualifying Recognition Event

Before a taxpayer can claim a loss deduction of any kind, there must be an event that qualifies for recognition. The event is usually a disposition. However, an investor may be able to write down or write off bad debts and worthless or partially worthless securities.

A worthless security may be charged off as a loss only when it becomes worthless [Treas. Reg. § 1.165-5]. Similarly, a prerequisite for a bad debt deduction is that the debt has become wholly (for nonbusiness bad debts) or partially (for business bad debts) worthless during the tax year [I.R.C. § 166(a)].

Obviously, worthlessness is a factual test, which has generated some rulings and case law.

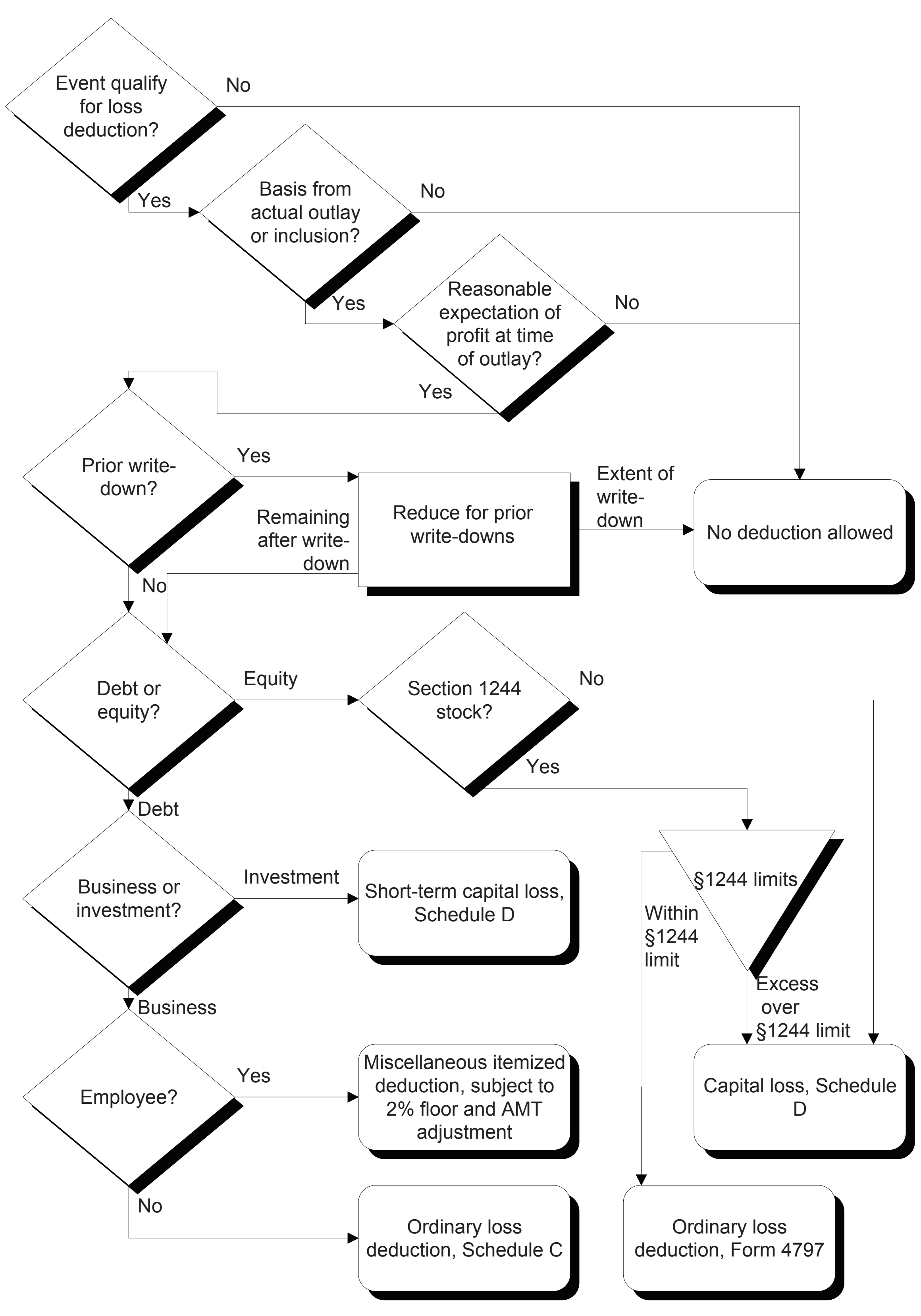
Actual Economic Outlay

A taxpayer claiming a loss deduction must be able to demonstrate that he or she has surrendered property and received less than the adjusted basis in the property at the time of disposition [I.R.C. § 1001]. When the asset is stock or debt in a corporation, determining the holder's initial basis is crucial. Courts have generally held that a contingent liability, such as a guarantee by a shareholder of a corporation's debt, does not rise to the level of economic outlay and thus does not create basis.

Observation Shareholder Must Make Payment to Have Basis

The economic outlay issue arises often in the case of S corporations when shareholders guarantee loans in an attempt to deduct losses from the S corporation. As noted in Issue 2 of this chapter, a shareholder obtains basis only when he or she actually pays on the guarantee, at which time the outflow of cash creates the requisite economic outlay.

Figure 13.12 Shareholder's Loss Deduction on Corporation's Failure



Example 13.8 Guarantee Does Not Provide Basis

Blake Hart is the sole shareholder of Bad Corporation, a music publisher taxed as an S corporation. In 2009, Bad Corp. applied for a loan from Sweet National Bank. Although Bad Corp. is the borrower, Blake guaranteed the $250,000 principal amount.

Blake's status as a guarantor does not give him an economic outlay until he actually pays all or a part of the principal amount. Therefore, if Bad Corp. fails, but Sweet National Bank never enforces Blake's guarantee, Blake has no allowable loss.

In some situations the shareholder may make a contribution directly to the corporation. However, the economic outlay might take the form of paying or assuming a corporation's loan from another creditor.

In *Putnam v. Commissioner*, 352 U.S. 82 (1956), an attorney guaranteed a debt for a corporation in which he was a shareholder. When the corporation was liquidated and there were insufficient assets to repay the creditor, Putnam paid the loan personally. The U.S. Supreme Court ruled that the shareholder's payment on the corporation's behalf created a debtor-creditor relationship via subrogation, and the loss qualified for a nonbusiness bad debt deduction.

The IRS explicitly sanctioned the use of substitution and subrogation to create basis in an S corporation in Rev. Rul. 75-144, supra. The Tax Court ruled that the substitution of borrowers, coupled with the consistent actions of all parties, created the requisite economic outlay in *Gilday v. Commissioner*, supra.

Motive for Investment

In general, tax law does not allow a deduction for a loss sustained on the disposition of property unless there was a profit motive for acquiring the property. Thus, an investor might not sustain a deduction if he or she had no reasonable expectation of economic return when the payment was made or if the payment was made for personal reasons. In most cases, some sort of deduction will be allowed if there is any kind of business relationship. However, the deduction may be in the form of a capital loss, either because the investment is connected with ownership rather than with a debtor-creditor relationship or because the loan is a nonbusiness loan.

In *Tigrett, III v. United States*, 213 Fed. Appx. 440 (6th Cir. 2007), a shareholder contended that a $5,000,000 payment he made to a corporation pursuant to an indemnity agreement should be treated as a business expense rather than as a contribution to capital. The court concluded that the payment was not a loss incurred in a trade or business or in a transaction entered into for profit because it was made pursuant to an agreement that the shareholder entered into voluntarily and without receiving any consideration.

The taxpayer in *Fox v. Commissioner*, 190 F.2d 101 (2d Cir. 1951), was paying a contractual obligation as a guarantor on an investment that had no recoverable value. Her obligation arose from guaranteeing her husband's brokerage account debt, and he had since died. The IRS argued that she was not entitled to a deduction because she had no reasonable prospect of recovery when she made the payment. However, the court held that she had a profit motive for entering into the guarantee in the first place, and her payment was in fulfillment of her legal obligation. Thus, the court allowed the deduction.

The *Putnam* case, supra, involved a shareholder's bad debt deduction for paying a debt of a troubled corporation. The Supreme Court held that the payment did not create a new debt but was merely a change of creditors on a single debt instrument. That may seem like a minor distinction, but it closed an IRS argument. The IRS argued that a new debt instrument issued by a borrower who was not able to pay could not pass muster as a transaction entered into with a profit motive. Because the Court found that Putnam had taken over an existing debt that was made and guaranteed with a profit motive, he was entitled to a deduction.

Acquisition Basis

The original transaction must be a transaction that results in basis to the holder. Thus a zero-basis obligation, such as a receivable owed to a cash-method taxpayer, does not give its holder any deductible loss amount [Treas. Reg. § 1.166-1(e)].

Example 13.9 Promised Income Never Collected

Bad Corp., from Example 13.8, accrued a $100,000 bonus to Blake at the end of 2010. Blake is a cash-method taxpayer. Blake has no basis in this receivable from Bad Corp., even though it might be an enforceable claim under nontax law. If Bad Corp. liquidates without paying the bonus to Blake, Blake cannot claim a tax loss.

Prior Reduction of Basis

If the investor made the requisite outlay and the profit motive is obvious, a tax adviser must next ascertain whether the original basis was eroded by events that occurred prior to the disposition. The investor may have sold or given away a portion of the original investment and needs to reduce basis accordingly. There may have been a write-down of a partially worthless business debt. The most frequent event that reduces basis is an investment in S corporation stock or debt that was followed by losses.

When a shareholder disposes of S corporation stock, all of the year's adjustments to basis for income, losses, and distributions occur immediately before the disposition [Treas. Reg. § 1.1367-1(d)]. If a shareholder disposes of debt but continues to hold stock in the S corporation, the adjustments to debt basis are made immediately before disposition of the debt [Treas. Reg. § 1.1367-2(d)(1)]. Similarly, if the shareholder disposes of all of his or her stock but continues to hold debt, the basis adjustments occur immediately before the disposition of the stock [Treas. Reg. § 1.1367-2(d)(1)].

Example 13.10 Adjustments to Basis before Disposition

Assume that Blake (from Examples 13.8 and 13.9) originally contributed $150,000 to Bad Corp. as a cash investment in stock. In addition, he loaned Bad Corp. $75,000. Thus, he had a $225,000 ($150,000 + $75,000) verifiable basis when Bad Corp. was formed in 2008.

In the years before 2011, Bad Corp. suffered losses and passed $180,000 of the losses through to Blake. Therefore, at the beginning of 2011, Blake's stock basis is zero and his debt basis is reduced by $30,000 ($180,000 – $150,000) to $45,000 ($75,000 – $30,000).

In 2011, Blake disposed of all of his stock and debt holdings for $1,000 in cash. His share of Bad Corp.'s 2011 losses before the disposition is $28,000. Blake must further reduce his debt basis to $17,000 ($45,000 – $28,000), and his loss on the disposition is $16,000 ($1,000 – $17,000).

Distinguishing Debt and Equity

Few tax issues are as prone to litigation as the distinctions between debt and equity in closely held corporations. The typical scenario involves a person who is both a shareholder and a purported creditor. The cases principally focus on one of three issues:

1. A C corporation claims an interest deduction for a payment to a shareholder, and the IRS treats the payment as a dividend.
2. A controlling shareholder in a C corporation tries to have the corporation redeem a prior infusion of cash or property. The IRS characterizes the transaction as a stock redemption, which likely fails the exchange tests of I.R.C. § 302(b).
3. A shareholder claims a bad debt deduction, rather than a loss on stock, when a corporation fails.

Courts have developed several indicia for distinguishing between debt and equity investments, including the following factors:

- The designation of the certificates evidencing the indebtedness
- The presence or absence of a maturity date
- The source of the payments
- The right to enforce the payment of principal and interest
- The creditor's participation in management
- The creditor's status being equal to or inferior to that of regular corporate creditors
- The intent of the parties
- Thin versus adequate capitalization
- Whether the creditor and stockholder are the same or different persons
- The source of interest payments

- The ability of the corporation to obtain loans from outside lending institutions
- The extent to which the advance was used to acquire capital assets
- The failure of the debtor to repay the debt on the due date or to seek a postponement

In *John Kelley Co. v. United States*, 326 U.S. 521 (1945), the Supreme Court pointed out that there is no one factor, not even exclusion from management, that distinguishes debt from equity. [See also *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986).] Thus a person who is intending to claim a bad debt deduction must sort through the various distinctions and see if the preponderance of evidence points to debt rather than to equity.

A tax professional may want to review numerous cases to assess the probability of success. However, before sacrificing too much time and effort, the parties may want to evaluate the business or investment rationale behind the investment. It would be a Pyrrhic victory to win an expensive battle to prove that an investment was debt if all that resulted was a nonbusiness bad debt deduction.

Character of Loss

Business bad debts are deductible as ordinary trade or business losses. The deduction for a nonbusiness bad debt is a short-term capital loss. In most cases, the loss on an equity investment in a corporation is capital, because most investors hold stocks as a capital asset. However, there are two possibilities for ordinary loss treatment on an equity investment:

1. The holder is a securities dealer and the stock in question is held in inventory at the time of its disposition or worthlessness.
2. The stock qualifies as I.R.C. § 1244 stock. This provision treats up to $50,000 (doubled for joint returns) of a loss on the disposition of qualifying stock as an ordinary loss. I.R.C. § 1244 is available only to individuals who acquired their shares in return for a contribution of money or other property to the corporation. There are several other criteria for this provision, but it can be useful for shareholders who sustain losses.

Cross-Reference I.R.C. § 1244 Stock

See pages 573–577 in the *2004 National Income Tax Workbook* for a discussion of the I.R.C. § 1244 loss rules.

Nonbusiness Bad Debts

Much of the case law on bad debts comes from the distinction between business and nonbusiness bad debts. Because a nonbusiness bad debt is treated as a short-term capital loss, it is subject to the capital loss deduction limit (generally, $3,000 in excess of the taxpayer's capital gains for the year). In addition, it may offset long-term capital gains that might otherwise qualify for a preferential tax rate.

The IRS and the courts have set a high hurdle for taxpayers to clear in claiming a business bad debt deduction. In the *Putnam* case, the taxpayer was an attorney who also co-founded a publishing corporation. He had guaranteed the corporation's debts and was able to show a profit motive, as discussed earlier. However, the courts rejected his argument for a business bad debt deduction, holding that "his venture into the publishing field was an investment apart from his law practice." His basis in both his worthless stock and the debt received capital loss treatment.

The Supreme Court heard a similar argument in *Whipple v. Commissioner*, 373 U.S. 193 (1963). The shareholder invested in numerous corporations and claimed that his involvement with these businesses should rise to the level of a trade or business. He held a franchise for distribution of soft drinks and owned 80% of the stock of a bottling corporation. He had advanced more than $50,000 to the corporation by the time the debt became worthless. In spite of his considerable energy and activity in ventures relating to the soft drink business, the Court characterized the debt as a nonbusiness bad debt because the shareholder was neither in the business of lending money to bottling companies nor personally in the business of bottling soft drinks.

"Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment,

this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself," the Court stated in *Whipple*.

The case of *United States v. Generes*, 405 U.S. 93 (1972), involved a shareholder-employee who had advanced the corporation about $300,000 through direct loans and indemnity agreements. He claimed a business bad debt deduction, asserting that protection of his job was the sole motive for the loans and guarantees. However, his salary from the corporation was only $12,000. Therefore, the Court found that his motivation was primarily that of an investor, which did not qualify for a business bad debt deduction.

Example 13.11 Character of Losses

The facts have changed from Example 13.10. Bad Corporation is a C corporation. Blake Hart paid $150,000 for stock, and he loaned the corporation $75,000. Bad Corp. never paid the $100,000 bonus described in Example 13.9. At the end of 2010, Blake's stock basis is $150,000 and he has a $75,000 basis in a note receivable from Bad Corp. He also was still a guarantor on the $250,000 loan from Sweet National Bank. Bad Corp. failed in 2011, but it had enough assets to pay off the bank loan. Blake recovered nothing.

Blake's $150,000 investment in Bad Corp. stock is a capital loss. He may be able to treat $50,000 (or $100,000 if Blake is married and files a joint return for the year) of the loss as an I.R.C. § 1244 loss that is an ordinary loss deduction. The remaining loss on the stock is deductible only as a capital loss.

The $75,000 note receivable might be treated as equity, or it might be a bad debt. Blake and his tax adviser need to run the gauntlet of business vs. nonbusiness bad debt categorization.

Blake may try to claim that the corporation's activities were integral to his own career as a musician, or that he regularly underwrites music publishing companies' obligations. These would be factual arguments, and he would need substantial evidence to support either claim.

Both *Generes* and *Whipple* made similar credible claims, but in each case the Supreme Court found that the primary purpose for making loans was related to shareholder's investment in the corporation. Thus, Blake will most likely be limited to capital loss treatment, either as an equity investment or as a nonbusiness bad debt.

Example 13.12 Payment of Loan Is Deductible

Change the facts from Example 13.11, so that Bad Corp. loses all of its assets as a result of a copyright lawsuit brought by another music publisher, Crazy Corporation. Blake then repays the entire $250,000 bank loan that he had guaranteed and can recover nothing from Bad Corp.

Blake is likely able to deduct the $250,000 under the rationale followed in the *Putnam* and *Fox* cases. However, he still faces the uphill battle of classifying the debt as a business bad debt.

Practitioner Note Loss Deduction Benefit

Choosing taxation as an S corporation rather than a C corporation can have some major benefits for the shareholder of a troubled corporation. The ordinary losses the business suffers on its downward journey pass through to the shareholder, so the shareholder can recoup the tax cost of the investment before the corporation's ultimate collapse. If the shareholder lacked basis to deduct all of the losses, stepping in at the last moment with a cash infusion or payment of a guarantee on the corporation's behalf gives the shareholder additional basis to deduct current and future losses. Thus, the questions of debt or equity, as well as the criteria for business and nonbusiness investment, become largely irrelevant

Example 13.13 S Corporation Debt Basis for Loss

Return to the facts in Example 13.10, so that Bad Corp. is an S corporation. The adjustments in Example 13.10 left Blake with a zero stock basis and a $17,000 debt basis. The catastrophic lawsuit in Example 13.12 leaves Bad Corp. with a $300,000 ordinary loss for the year, and Blake pays $250,000 to Sweet Bank to satisfy his guarantee.

Blake's payment is likely to satisfy the economic outlay and business purpose tests described in the *Putnam* and *Fox* cases. Moreover,

he can reasonably assume that the IRS would not challenge his economic outlay, based on Rev. Rul. 75-144. Thus, the $250,000 outlay will boost his debt basis to $267,000, which allows him to deduct $267,000 of the $300,000 Bad Corp. flow-through loss. The question of a bad debt or capital loss deduction for the residual losses becomes moot, because he has no basis remaining.

Employee's Business Bad Debt Deduction

Several taxpayers in the cases cited in this discussion were employees of the corporations. The shareholder in *Generes* argued for a business debt deduction based on his employment by the corporation. But in 1962, the year at issue in *Generes*, unreimbursed employee expenses were deductible in arriving at adjusted gross income (AGI), whereas the capital loss deduction was limited to capital gains plus $1,000.

In the post-1986 environment, taxpayers might find that an employee business bad debt is not necessarily desirable. An unreimbursed employee expense is now a miscellaneous itemized deduction, subject to the 2%-of-AGI floor. Moreover, the deductions that overcome that obstacle become alternative minimum tax adjustments and may yield a negligible, if any, tax benefit.

The Tax Court held that the 2%-of-AGI rule did apply to an employee business bad debt deduction in *Graves v. Commissioner*, T.C. Memo. 2004-140. The IRS conceded that the taxpayer made bona fide loans to maintain his employment with his trucking company and that the loans became worthless during 1996 because of the company's bankruptcy. But the court agreed with the IRS that the taxpayer was not in the trade or business of lending money; rather, he was in the trade or business of operating a trucking company as an employee.

Payment of Corporate Expenses

The cases previously cited in this section focused on the I.R.C. § 166 bad debt deductions. On occasion, taxpayers who paid expenses on behalf of corporations have been allowed an ordinary trade or business deduction pursuant to I.R.C. § 162.

The case of *Lohrke v. Commissioner*, 48 T.C. 679 (1967), has been cited numerous times in the Tax Court, U.S. district courts, and several U.S. circuit courts of appeal. Lohrke was an inventor and patent licensor who owned about 61% of a financially troubled corporation that manufactured and sold a product for which Lohrke was paid substantial royalties ($172,648.28 for 1962, the year at issue). The corporation sent a defective shipment of the product, and Lohrke sent a $30,000 personal check to the corporation's customer to cover the losses that ensued. Lohrke testified that he felt that this was the only way to protect the product's reputation and future sales and therefore to protect or promote his own licensing business outside the corporation. The court accepted that motive and held that the payment was a deductible expense for the patent licensing business.

One of the more amusing cases involving a taxpayer who was allowed to claim trade or business deductions for his own expenditures, even though the expense originated with a corporation, is *Jenkins v. Commissioner*, T.C. Memo. 1983-667. The late Harold Jenkins was a musician who used the stage name Conway Twitty. He had founded a corporation, Twitty Burgers, Inc., to develop fast food restaurants. The corporation failed, and Jenkins reimbursed several investors, including Merle Haggard, for their losses. Jenkins had no other significant activities in the food business, but he claimed that the repayments were ordinary trade or business deductions to protect his reputation in the music industry. The crux of the argument was that his trade or business depended on his business reputation. The court found that Jenkins did not make the payments to revitalize the corporation or to enhance the value of his investment and said it was convinced that he repaid the investors with the primary motive of protecting his personal business reputation. The judge wrote a footnote in verse to conclude the case, called *Ode to Conway Twitty*, that ends thusly:

> In order to allow these deductions
> Goes the argument of the Commissioner
> The payments must be ordinary and
> necessary
> To a business of the petitioner.
> Had Conway not repaid the investors
> His career would have been under cloud,
> Under the unique facts of this case
> Held: The deductions are allowed.

Liability after Dissolution

Dissolution of a corporation can be a hazardous action. Some state laws create transferee liability to protect creditors of defunct corporations. In this situation, the hapless final shareholders of defunct corporations may be subject to claims against the corporation that arise after the dissolution.

In a landmark Supreme Court decision [*Arrowsmith v. Commissioner*, 344 U.S. 6 (1952)], shareholders were obligated to pay a judgment against a liquidated corporation that was rendered 4 years after the shareholders had received the final liquidating distribution. The shareholders claimed ordinary deductions for the repayments, and the IRS reclassified the payments as contributions to the defunct corporation.

Receipt of property in liquidation of a corporation generally results in capital gain or capital loss. The IRS reasoned that the shareholders' payments of the judgment should be treated as capital losses, because the payments had the economic effect of reducing the proceeds the shareholders had received in liquidation of the corporation. If the corporation had made the payments before liquidation, the shareholders would have received less for their stock and would have calculated a reduced capital gain or increased capital loss as a result of the liquidating distribution.

The Supreme Court upheld the IRS's reasoning and limited the former shareholders to capital loss treatment.

Summary

When this material was written, the United States was still going through a recessionary period with a more-than-9% unemployment rate nationwide. Many small businesses were on the brink of failure, and their investors may not have been willing or able to continue financial support.

Except for a few entrepreneurs, such as some venture capitalists, the most likely treatment for writing off a debt or stock investment is a capital loss. Taxpayers who have multiple business activities that have some relationship to each other may be able to sustain an ordinary deduction under the *Lohrke* rationale. However, absent an S corporation election, the majority of these situations will not permit the shareholders to deduct ordinary losses.

An S corporation election allows losses to pass through to shareholders and retain their character. The losses reduce shareholder basis, so that there may not be any substantial basis remaining when the corporation goes under. Meanwhile, the investor has claimed ordinary loss deductions, basis permitting. If the shareholder has suspended losses because of the I.R.C. § 469 passive-activity loss rules, the complete disposition of the shareholder's interest in the entity allows the deduction in the year of disposition (subject to the basis and at-risk rules).

ISSUE 4: SALE OF ENTITY WITH DEBT

When a lender accepts property in return for debt relief, the borrower is treated as selling the property to the lender. If a business is purchased for less than the full value of its assets, basis must be allocated using a residual method.

An economic downturn may lead to an anticipatory selling of investments that allows the current owners to build up liquidity or to salvage other investments. Accordingly, a negative synergy may be associated with a going business, and a savvy purchaser may be able to acquire an entire business for less than the value of the most desirable components. Of course, this may also mean taking some unwanted assets to make the deal go through.

As used here, the term *bargain sale* describes a situation where an entire business entity (or an undivided interest in the component parts of an entire entity) is priced at an amount that is lower than the amount that might be realized upon the sales of the components separately. The seller's pressing financial needs, or legal pressures for a quick divestiture, might preclude the orderly liquidation of the assets for the best realizable price over an extended time period.

At any rate, the situation arises, and special tax rules may affect both the buyer and the seller. This material uses the term *target company*

to describe the business unit that is being sold, purchased, or otherwise exchanged.

Property Transfer to Creditor

Virtually every business has debt associated with its operations, but a distressed company may have debt that approaches, or even exceeds, the value of the assets. The buyer must ascertain the amount of debt as part of the due diligence study incorporated in the purchase negotiation. The parties should then agree on what will happen to the debt. The lenders often play an important role in these negotiations. In some cases the lender acquires a partial interest or complete ownership in the target company.

Relief from Liabilities

When a buyer relieves a seller of liabilities in a transfer of a business, the liabilities are treated as consideration received, just as though the seller gave cash and the buyer used the cash to satisfy the liabilities. When a debtor transfers property to a lender in exchange for debt relief, the debtor is treated as selling the property to the lender.

Whether the liabilities were recourse or nonrecourse may affect the seller's reporting.

- A *recourse liability*–typical in commercial financing deals–occurs when the borrower signs an unconditional promise to pay even though the borrower also pledges the property (such as the building, automobile, or other asset) for which the liability was incurred to secure the loan.
- A less common form of financing is nonrecourse lending for the purchase of property. With a *nonrecourse loan*, the property is the only security for the loan and the lender can take no action other than repossession if the borrower defaults. A borrower is able to negotiate this advantageous position in some commercial deals, but usually the most likely source of nonrecourse financing is a private sale or a negotiated deal with an unregulated lender.

Thus, both types of loans can be found, and a tax professional needs to ascertain the character of each debt.

Relief from Nonrecourse Liabilities

Because the lender is limited to claiming the property and has no other recourse against the borrower, the relief of liability from a nonrecourse debt that is associated with a transfer of property is treated as the property's sale price. Accordingly, there is no question as to whether the former owner has any cancellation of debt income (CODI).

The Internal Revenue Code expressly provides that the property's FMV for determining gain or loss cannot be treated as less than the nonrecourse debt to which it is subject [I.R.C. § 7701(g)]. The U.S. Supreme Court has held that a nonrecourse liability is treated as the transferred property's sales price even if the liability exceeds the property's actual fair market value (FMV) [*Commissioner v. Tufts*, 461 U.S. 300 (1983)].

Example 13.14 Relief from Nonrecourse Loan

Roger Rich owes $250,000 on a nonrecourse basis to Deadwood National Bank. Roger's basis in the corporation stock that he pledged as security for the loan is $180,000, and the stock's FMV is $200,000. Roger transfers the stock to the lender, who can take no further action against Roger.

Roger is treated as selling the stock for the $250,000 he owed to the bank. Therefore, Roger recognizes a $70,000 capital gain ($250,000 – $180,000). The gain cannot be excluded from gross income using any of the CODI rules.

Relief from Recourse Liabilities

In general, the same principles apply to a foreclosure or other transfer of property involving a recourse debt. In this circumstance, however, the mortgagor still has a claim against the debtor if the property's FMV is less than the obligation. If the creditor pursues no other remedies and accepts the property in cancellation of the debt, the liability is bifurcated:

1. The amount of canceled debt that does not exceed the property's FMV is treated as an amount realized on the sale of the property. The character of this gain or loss is determined by the usual tax rules, and it may be capital, I.R.C. § 1231, or ordinary gain.

2. The amount of canceled debt that exceeds the property's FMV is CODI [Treas. Reg. § 1.1001-2(a)(2)]. This portion of the debt cancellation can be only ordinary income (subject to special exclusion rules), and it is treated in the same manner as a cancellation of debt that does not include a transfer of property.

Example 13.15 Relief from Recourse Loan

The facts are the same as in Example 13.14, but Roger's liability was recourse debt, and Deadwood Bank canceled the entire debt. The $20,000 ($200,000 – $180,000) excess of the stock's FMV over Roger's basis is his gain on the disposition. The $50,000 ($250,000 – $200,000) excess of the liability over the stock's FMV is CODI that is subject to the I.R.C. § 108 exceptions to inclusion in gross income. If none of the CODI is excludable, Roger's total income from the transfer is $70,000 ($20,000 + $50,000), as in Example 13.14, but the character of the income has changed.

A lender who accepts property in satisfaction of a debt treats the cancellation of debt that exceeds the property's value as a bad debt for tax purposes. The criteria for business and nonbusiness bad debts apply in determining any tax deduction. When a write-down of debt is connected with the property transfer, the lender's basis is the property is its FMV (which corresponds to the balance of the debt after the write-down).

Example 13.16 Lender's Basis after Repossession

After taking title to the property in Example 13.15, Deadwood Bank claims a $50,000 bad debt deduction, equal to Roger's cancellation of debt income. Deadwood's basis in the property is its $200,000 FMV.

Liability Included in Purchase Price

When the buyer of a target corporation is not a creditor, the price paid is usually assumed to be the business's FMV, including the value of its intangibles. If the buyer assumes debt associated with the business, the total debt assumed plus any other consideration paid is considered to be the FMV. However, in some instances this presumption may not be correct.

- If the buyer and the seller are related parties, there may be an implicit gift.
- The transfer may be only part of a larger deal.

In these circumstances, a tax professional should ascertain all of the consideration that is involved, even though it might not be expressly stated.

Cancellation of Debt Income

When a lender acquires a debtor's business and the FMV of all of the assets transferred is less than the face value of the outstanding debt, there is CODI equal to the excess debt. The seller must then determine whether one of the I.R.C. § 108 exclusions applies. If not, the CODI is included in gross income at the time of the debt relief.

Cross-Reference Cancellation of Debt Income

See the "Real Estate" chapter of this book for more information about sales of distressed property and cancellation of debt income.

Figure 13.13 gives a brief overview of I.R.C. § 108 as it applies to debts connected with trade or business activities.

Figure 13.13 Exclusions for Cancellation of Debt Income in a Business Context

Taxpayer's Title 11 case?
Yes
No
Insolvent before discharge?
Yes
Insolvent after discharge?
Yes
No
Sort
Amount not solvent
Amount Solvent
No
Seller financing?
Yes
No
Qualified farm debt?
Yes
Exceed basis of property?
No
Yes
Sort
Not in excess of basis
Excess over basis
No
C corporation?
No
Qualified business real property debt?
Yes
Exceed basis of property?
No
Yes
Sort
Not in excess of basis
Yes
No
Excess over basis
Reduce basis
Include
Exclude

Reduction of Favorable Tax Attributes

CODI exclusions under the bankruptcy and insolvency exceptions require the taxpayer to reduce certain favorable tax attributes, as follows:

1. Net operating loss (NOL) of the year of discharge
2. NOL carryover to that year
3. General business credit carryforward
4. Alternative minimum tax credit carryforward from years prior to discharge
5. Capital loss of the year of discharge
6. Capital loss carryover to the year of discharge
7. Reduction of basis of all property held by the taxpayer
8. Passive-activity loss and credit carryforwards from the year of the discharge
9. Foreign tax credit carryover

The seller financing, qualified farm debt, and qualified business real property debt exclusions require reduction of the basis of the property. If the canceled debt exceeds the basis of the property, the excess is CODI to be included in the debtor's gross income at the time of the debt reduction.

Cross-Reference Tax Attribute Reduction

See pages 153–158 in the *2010 National Income Tax Workbook* for more information about the tax attribute reduction requirements.

Special Rules for Partnerships and S Corporations

When a partnership's debt is canceled, the CODI exceptions for bankruptcy, insolvency, qualified farm indebtedness, and qualified business real property indebtedness rules apply at the partner level, even though the debt was a partnership debt [I.R.C. § 108(d)(6)]. Tax attributes are also reduced at the partner level, so it is possible for the various partners to have disparate tax treatments.

The unique nature of S corporations requires some special calculations. If the corporation is the debtor, the required reduction of tax attributes is generally applied at the corporate level. However, there is one shareholder-level tax attribute for which reduction is required.

Prior-year losses that are suspended by the shareholder under the basis limitations are treated as NOL carryovers from years prior to the year of discharge [I.R.C. § 108(d)(7)(A)]. The shareholder-level loss carryforward that must be reduced under this rule includes all losses from previous years, as well as the current year's loss.

Asset Sale vs. Sale of Entity

If the transfer of all or part of a going business does not qualify as a tax-free reorganization, the transaction is taxable to the seller and gives the buyer a fresh basis in the property acquired. If there is no business entity, as with a proprietorship, the transfer can only consist of the individual assets. However, when a business entity [partnership, corporation, or limited liability company (LLC)] is involved, the transfer may be either

- a sale of the assets from the business entity to the new owners; or
- a sale of interests in the entity by the old owners to the new owners.

Although a layman may see little difference between the two forms of transfer, the tax consequences may differ markedly.

Practitioner Note Nontax Considerations for Purchaser

Perhaps the most important issue in the sale of a business is for both the buyer and seller to know exactly what property is changing hands. In general, a buyer prefers to purchase assets rather than the entity.

- If the entity has undisclosed or unknown liabilities and the buyer purchases assets from the entity, the entity retains its undisclosed liabilities, which will ultimately be borne by the seller.
- However, if the entity has some valuable nonassignable contract or other right, the only feasible way to structure the deal may be a sale of the entity.

In that case, the buyer needs to know what tax elections are in place for the business, such as whether an LLC is a C corporation, S corporation, or unincorporated enterprise for tax purposes.

Applicable Asset Acquisitions

The I.R.C. § 1060 rules for the sale of a going business apply to certain transfers of business assets, regardless of the entity form of the buyer or the seller.

Allocation Formula

I.R.C. § 1060(a) requires the use of a specific allocation formula in an *applicable asset acquisition.* This event occurs whenever there is a taxable transfer of a going business or enough of a business that goodwill or going-concern value changes hands. Thus, it does not apply to a tax-free transfer or to a sale of assets that are severed from the business.

If I.R.C. § 1060 applies, the exchange price must be allocated to the individual assets transferred in the deal using the *residual method.* This method is a step allocation to seven classes of assets [Treas. Reg. § 1.1060-1(c)(2)]. At each step, the amount allocated to the class and the assets within the class is the lesser of the total consideration paid (minus any consideration allocated to a senior class) or the identifiable FMV of the assets, whichever is less. The asset classes from Treas. Reg. § 1.338-6(b) are shown in Figure 13.14.

Figure 13.14 Asset Classes for Residual Method

Class	Description
I	Cash and demand deposits
II	Certificates of deposit and government and marketable securities
III	Accounts receivable incurred in the ordinary course of business
IV	Inventory
V	All tangible assets not included in other classes
VI	Intangible assets other than goodwill and going-concern value
VII	Goodwill and going-concern value

Within each class, the price assigned to each asset is generally the asset's FMV. But if the sales price is not sufficient to completely fill up any class, the assets within that class are assigned ratable portions based on their FMV.

Practitioner Note Residual Method Is Mandatory

I.R.C. § 1060(a) states that if the buyer and seller agree in writing to an allocation of the consideration or FMV, the agreement is binding on both the buyer and the seller. Even without a written agreement, both parties must use the residual method in figuring gain or loss and basis for tax purposes.

If the consideration paid exceeds the values of tangible assets, the excess price is assigned to intangibles. The final two categories contain these assets: Class VI includes intangibles other than goodwill and going-concern value, whereas Class VII represents the amounts associated with those last two assets.

Even when there is a written agreement as to the FMV of each asset, the amounts reported by buyer and seller will often differ. The seller reduces the amount realized by any selling costs, whereas the buyer increases the amount paid to reflect any purchase costs. Thus legal fees, due diligence costs, brokerage fees, and other such incidentals will typically cause the buyer's basis to be greater than the seller's amount realized on the sale. The usual effect of this imbalance appears in the amount allocated to goodwill.

Asset Allocations in Bargain Sales

If the whole is less than the sum of the parts, the bargain element (that is, the shortfall of the consideration over the sum of the individual values) works through the classes in reverse order. In other words, any goodwill or going-concern value associated with the business is reduced first.

Example 13.17 Sale of All Assets at Bargain Price

Buyme Corporation has been reasonably profitable, but its market has recently become volatile and somewhat distressed. Accordingly, prospects for future business look risky. Mitch Sellall, the sole shareholder, is facing health problems and personal financial troubles and wants to cash out quickly. The Buyme balance sheet, assuming an orderly sale of each asset for its highest and best use, is shown at basis and fair market value. Note that the FMV of most assets is less than the asset's book value.

Figure 13.15 Buyme Corporation's Assets and Liabilities

	Adjusted Basis	FMV
Assets		
Cash	$ 48,000	$ 48,000
Accounts receivable (accrual method)	202,000	197,000
Working capital invested in marketable securities*	127,500	67,500
Vehicles, office equipment, and furnishings (cost)	175,000	60,000
Accumulated depreciation	(82,000)	
Land	250,000	225,000
Building (cost)	540,000	510,000
Accumulated depreciation (straight line)	(68,000)	
Total	$1,192,500	$1,107,500
Liabilities and Equity		
Trade payables	$ 200,000	$ 200,000
Mortgage on land and building	400,000	400,000
Capital stock	150,000	507,500
Retained earnings	442,500	
Total	$1,192,500	$1,107,500

* For simplicity, assume that this asset is a single block.

Greenbacks offered to purchase all of Buyme's assets for $250,000 plus assumption of all liabilities, and Mitch accepted the offer. The total sales price is $850,000 [$250,000 cash + $600,000 ($200,000 + $400,000) of liabilities to be assumed]. Greenbacks and Mitch must each file Form 8594, Asset Acquisition Statement Under Section 1060, and show the values allocated to each class of assets.

Cross-Reference Completed Form 8594

See page 354 in the *2010 National Income Tax Workbook* for an example of a completed Form 8594.

The total consideration is first allocated among the classes in order of seniority, starting with Class I. Figure 13.16 shows the Buyme allocation. The available amount is the total consideration minus the amount(s) allocated to the more senior class(es). The allocation amount is the lesser of the available amount or the FMV of the assets in the class.

Figure 13.16 Allocation among Buyme's Asset Classes

Class	Assets	FMV	Available Consideration	Allocation
I	Cash	$ 48,000	$850,000	$ 48,000
II	Marketable securities	67,500	802,000	67,500
III	Accounts receivable	197,000	734,500	197,000
IV	Inventory	0	0	0
V	Other tangible assets	795,000	537,500	537,500
VI	Other intangible assets	0	0	0
VII	Goodwill and going-concern value	0	0	0
	Total	$1,107,500		$850,000

The second step in the allocation is to assign an amount to each asset within a class. Because there is only one asset per class for Classes I, II, and III, there is no further breakdown among the individual assets. However, the total value assigned to the Class V assets is apportioned among them according to the relative FMV of each asset.

The second-tier allocation is shown in Figure 13.17. For simplicity's sake, the entries for vehicles, office equipment, and furnishings are shown as a group, but each individual asset must be assigned its own price.

Greenbacks can then determine its opening balance sheet for Buyme Corporation, using the assets' allocated values.

Adjustment for Transaction Expenses

In this simplified example, the $850,000 available consideration is not adjusted for selling expenses or purchase expenses, but those would affect the amount allocated to the Class V assets, because the available consideration was less than the aggregate FMV of the assets in that class.

Figure 13.17 Buyme Corporation's Assets in Class V

Asset	Separate FMV	Percentage of Total FMV	Allocated Cost
Vehicles, office equipment, and furnishings	$ 60,000	7.5472%	$ 40,566
Land	225,000	28.3019%	152,123
Building	510,000	64.1509%	344,811
Total	$795,000	100.0000%	$537,500

Figure 13.18 Buyme's Beginning Balance Sheet after Acquisition

Assets	
Cash	$ 48,000
Accounts receivable (accrual method)	197,000
Working capital invested in marketable securities	67,500
Vehicles, office equipment, and furnishings	40,566
Land	152,123
Building	344,811
Total	$850,000
Liabilities and Equity	
Trade payables	$200,000
Mortgage on land and building	400,000
Capital stock	250,000
Total	$850,000

No Negative Goodwill for Tax Purposes

For financial accounting purposes, some companies will record the individual assets at their identifiable FMVs, and record a negative goodwill allowance to reflect the total value. Whatever the merits of this treatment might be for financial accounting purposes, it is not permitted for tax purposes.

Sale of Business Interests

When a target business is an entity (such as a partnership, LLC, C corporation, or S corporation), the parties may structure the acquisition as an ownership unit transfer rather than as an asset transfer. Treatises and articles abound on the pros and cons of the two types of transactions. A direct asset sale has much to commend it, but other circumstances may dictate a transfer of the business entity.

The sale of ownership units (such as corporate stock, partnership interests, or LLC interests) has one particular possible advantage if there are assets that are worth less than their book value: The residual allocation method prescribed by I.R.C. § 1060 does not apply, so the individual assets may be able to retain their historic basis, avoiding a step-down.

However, each of the different business entities has some complications that may diminish the apparent tax advantages.

Partnership Interest

The sale of a partnership interest will result in a cost basis to the new owner. In some cases, the basis of the assets inside the partnership is unchanged. However, the following rules might apply to the partnership after the transfer:

- If the partnership has an I.R.C. § 754 election in effect, the partnership must adjust the basis of its assets by the difference between the former partner's outside basis and the new partner's outside basis to reduce the difference between the new partner's outside basis and the new partner's share of the inside basis of partnership properties. Even if the partnership does not have an I.R.C. § 754 election in effect, if the prior partner recognizes a loss that exceeds $250,000 the partnership must adjust the inside basis downward to the detriment of the new partner. The allocation rules of I.R.C. § 1060 apply to these reallocations.
- If there is a sale or exchange of 50% or more of the partnership during a 12-month period, the partnership is considered terminated for federal income tax purposes. Each partner is deemed to receive its share of partnership assets in a liquidating distribution, which will equate the asset basis to the partner's

acquisition basis. The partners, new and old, are then treated as forming a new partnership, and each is given credit for the basis of assets deemed contributed. If one person acquires all of the partnership interests, that person is treated as acquiring all of the assets of the partnership. The basis in the assets is the same as the amount paid for the partnership interests.

Cross-Reference Transfer of Partnership Interests

The accounting treatment of the transfer of a partnership interest and its after effects can become quite complicated, even in relatively simple fact patterns. The *2008 National Income Tax Workbook* contains a discussion and examples of some of these problems on pages 454–476.

C Corporation Stock

Acquisition of C corporation stock gives the new owner a cost basis in the stock. However, a stock acquisition does not affect the basis of assets inside the target corporation. A corporation's ability to use its own tax attributes (such as NOLs and built-in losses) is restricted after an ownership change [I.R.C. § 382]. If assets have declined in value, the differences between the identified FMVs and asset bases (see Figure 13.15) are built-in losses, but the overall step-down required by I.R.C. § 1060 is not a built-in loss.

S Corporation Stock

Acquisition of S corporation stock gives the new owner a new stock basis, as it does when a C corporation is the target. Similarly, new ownership does not affect the basis of the assets inside the target corporation. The I.R.C. § 382 limits on a corporation's use of its tax attributes do not apply to an S corporation after an ownership change. However, the new shareholder's basis will limit his or her ability to deduct losses and receive tax-free distributions from the S corporation.

Summary

The general rule that stock purchases are better than asset purchases is a generalization at best, and it may backfire from a tax point of view when the overall value of a business is less than the value of the sum of its parts.

In this scenario, the entity acquisition may provide the best tax advantages to the new owner. However, this is also a generalization that may not be applicable in all circumstances. Moreover, nontax aspects may dictate one form of acquisition over the other.

If the target has certain nonassignable rights, an entity acquisition may be the only feasible route. In contrast, if there are likely to be hidden claims against the entity, an asset acquisition may provide the purchaser with better security.

In no case should any business acquisition be undertaken without a thorough due diligence study. Although the tax benefits or burdens of one form of acquisition over the other may be significant, the nontax aspects can be much more problematic.

ISSUE 5: PURCHASE OF REAL ESTATE

Who should hold title when a C corporation needs to acquire land and buildings? This section explores the tax effects of four options for one family-owned corporation.

The given fact pattern starts with a family farm, but the analysis of the pros and cons of each option will be the same for a nonfarm business.

The family corporation has three shareholders. The grandfather owns 55% of the stock after giving his son a 40% interest and his granddaughter a 5% interest. They plan to purchase more land and buildings for $1,000,000 and make an additional $1,000,000 of building improvements.

Brown Farms, Inc.

Brown Farms, Inc. is a C corporation with three shareholders: John Brown (grandfather, age 71), Jim Brown (John's son, age 48), and Charlene Brown (John's granddaughter, age 28). All three work on the family farm, which was incorporated 80 years ago by James Brown (John's father), who willed it to John. The farm has been very profitable over the years and has expanded dramatically. Its value was recently appraised at $4,500,000, but the shareholders' aggregate basis is its $1,000,000 fair market value (FMV) in James Brown's estate. After John gave interests to Jim and Charlene, their individual bases are $550,000, $450,000, and $50,000, respectively. The Brown Farms balance sheet is shown in Figure 13.19.

Figure 13.19 Brown Farms, Inc. Balance Sheet

Assets		Liabilities and Owners' Equity	
Cash	$ 550,000	Current liabilities	$ 300,000
Other current assets	150,000	Mortgages payable	1,000,000
Plant, property, and equipment—net	1,000,000	Total liabilities	$1,300,000
Land	1,000,000	Common stock	20,000
		Retained earnings	1,380,000
Total assets	$2,700,000	Total liabilities and equity	$2,700,000

Family Information

John's wife died 7 years ago, leaving all her assets to John, as no estate planning was completed. John wants to make certain that his estate is properly designed for estate tax, income tax, and disposition planning purposes. He has four children, but Jim is the only one involved in the farm.

Jim is married and has three children. Two of his children have no connection with the business, but Jim's daughter Charlene is active in the farm. Jim wants Charlene to be compensated over time for her service to the corporation, and he plans on Charlene taking over when he retires in 20 years. Charlene is unmarried and has no children. Figure 13.20 shows each shareholder's personal assets.

Figure 13.20 Shareholder Assets

	John	Jim	Charlene
Brown Farms, Inc. stock	$2,475,000	$1,800,000	$225,000
Personal residence	275,000	325,000	
Savings and investments	2,625,000	475,000	5,000
Other assets	100,000	100,000	1,000
Anticipated inheritance (current value)		2,000,000	
Total assets	$5,475,000	$4,700,000	$231,000

Options and Assumptions

The family wants to expand the farm by purchasing land with improvements for $1,000,000 and spending an additional $1,000,000 for more building improvements. Four options are being considered:

1. Have Brown Farms, Inc. purchase the property and make the improvements.
2. Have John purchase the property, make the improvements, and rent the property to Brown Farms.
3. Form an LLC (JJC Family LLC) with John, Jim, and Charlene as equal owners to pur-

chase the property, make the improvements, and rent to Brown Farms.

4. Have Brown Farms purchase a 15-year term interest in the property and improvements, with JJC Family LLC purchasing the remainder interest.

The following assumptions were used in analyzing the federal tax effects of each option:

- John Brown will die in 2023, 12 years from now.
- Values in 2026 will be needed for the split-interest computation.
- The farm might be sold in 2031 when Jim retires.
- The annual rate of growth in both the corporation and the new property is expected to be 6%.
- The loan for the new property will be $1,600,000, financed over 15 years at 5%, with a $12,652.70 monthly payment.
- Brown Farms's annual corporate income before the expansion is about $250,000.
- Earnings from the new venture before depreciation will be about $300,000.

All computations in the analyses are made using simplified summaries of income tax rates and estate tax rates, and the computations are rounded for ease of presentation. Figure 13.21 shows the presumed key values for Brown Farms and the new venture.

Figure 13.21 Projected Values on Key Dates

Year	Brown Farms	New Venture
2011	$ 7,500,000	$ 400,000 (net of loan)
2023	$ 9,228,379	$3,668,488 (net of loan)
2026	$11,043,421	$4,908,187
2031	$14,895,920	$6,620,409

Analysis of Corporate Purchase

A common option when planners are not consulted is for a C corporation to purchase the new venture assets.

Income Tax Effects

The corporation's historic income would increase by the net income of the new venture, computed as shown in Figure 13.22.

Figure 13.22 Projected Increase in Brown Farms's Income

Historic income	$250,000
New venture earnings (before depreciation)	300,000
New venture depreciation (average annual amount over 10 years)*	(120,000)
Total estimated annual income	$430,000

* After year 10, depreciation would be complete for tax purposes, and taxable income is estimated at $550,000 per year.

Brown Farms would pay a 34% federal income tax on its taxable income. Therefore, its tax would be $146,200 on $430,000 of income in each of the first 10 years and $187,000 on $550,000 of income in later years. In many states, the state income tax would be partially offset by investment credits.

Accumulated Earnings Tax

A corporation with this level of income must be aware of the I.R.C. § 531 accumulated earnings tax, which could be addressed by paying additional salaries (possibly raising reasonable compensation issues) or declaring dividends.

The tax may become an issue if the accumulated earnings exceed $250,000. The tax rate is 15% through 2012, but for 2013 and later years it is scheduled to equal the highest individual income tax rate imposed on single filers.

Accumulations in excess of $250,000 may not be unreasonable and therefore not subject to the tax. An accumulation is unreasonable if it exceeds the amount a prudent person considers appropriate for the business's present and reasonably anticipated future needs.

Brown Farms's retained earnings in 2011 were $1,380,000, in anticipation of its acquisition of the additional land and buildings.

Estate Tax

On the assumed death of John Brown in 2023, with both the current corporate value plus the new venture's value, the corporation will be valued at $12,896,867 ($9,228,379 + $3,668,488). John's executor will include $7,093,277 (55% of the $12,896,867 value, ignoring discounts) in John's estate. With his other assets, John's gross estate is likely to be about $13,000,000. Under current law, the estate tax would be about $2,800,000.

Difficult discussions will be needed about what assets should be left to Jim and Charlene to the detriment of the remaining heirs.

Asset Transition (Sale of Farm)

In a simplified model for the sale of farm assets in 2031, with all assets held by the corporation, the gain is subject to two full levels of tax.

Corporate Level

The calculation of the predicted gain to Brown Farms is shown in Figure 13.23.

Figure 13.23 Expected Gain on Sale of Farm Assets

Item	Amount
Sales price of farm interests	$21,516,329
Corporate basis in assets	
New venture land	(800,000)
Other land	(1,000,000)
Other assets	(500,000)
Corporate gain	$19,216,329

The tax on the $19,216,329 corporate gain at a 40% combined federal and state rate would be $7,686,532.

Individual Level

Brown Farms would then distribute the net proceeds to the shareholders. The net proceeds are $13,829,797 ($21,516,329 – $7,686,532 tax burden). Because this is a liquidating distribution, the shareholders report it as a sale of their stock, paying tax on only the difference between their bases and the distribution.

Figure 13.24 shows the shareholders' bases in the corporation before the distribution. The stepped-up basis at John's death is the same regardless of which heirs receive John's shares.

Figure 13.24 Shareholder Basis in Brown Farms

Shareholder	Basis
All (stepped up at John's death)	$7,093,277
Jim (original gift shares)	400,000
Charlene (original gift shares)	50,000
Total	$7,543,277

Overall, the shareholder's gain on liquidation of the corporation will be $6,286,520 ($13,829,797 – $7,543,277). Assuming a 20% combined federal and state tax rate on long-term capital gains, the shareholders together will pay $1,257,304 (20% × $6,286,520) on their liquidating distributions. The after-tax distribution will then be $12,572,493 ($13,829,797 – $1,257,304).

Analysis of Majority Owner Purchase

The second option for expanding the farm business is for John to purchase the property and lease it to the corporation. This is sensible from a financing standpoint because John has the substantial assets needed to support the required loan.

Income Tax Effects

The income tax effects for both John and Brown Farms should be considered.

Corporate Level

If the fair value rental for the land is $250,000, the corporate income will be $345,000, as shown in Figure 13.25. The federal income tax at this level of corporate income is about $117,300 (34% × $345,000).

Figure 13.25 Brown Farms's Income with Rent Payment

Item	Amount
Historic income	$250,000
New venture earnings	345,000
New venture rent payment	(250,000)
Total estimated annual income	$345,000

Individual Level

John's individual income tax return would show about $85,000 more income, as illustrated in Figure 13.26, and his federal and state income taxes would increase by about $34,000 at a 40% combined rate.

Figure 13.26 John Brown's Net Rental Income

Item	Amount
Rent received	$250,000
Interest on loan (average for first 10 years)	(45,000)
Depreciation (average for first 10 years)	(120,000)
Total rental income	$ 85,000

John would have a $65,000 positive after-tax cash flow in the first 10 years, because principal payments on the loan would average about $106,000 per year ($250,000 rent – $45,000 interest – $106,000 principal payment – $34,000 income taxes = $65,000). After 10 years, the depreciation would be complete, and the after-tax cash flow would diminish by $48,000 ($120,000 depreciation deductions × 40% tax rate) until the mortgage is paid in full.

In summary, a majority shareholder purchase will not significantly change the federal income tax results on the same $430,000 of taxable income ($345,000 + 85,000), assuming that John's income is significant before the rental income. The combined lessor-lessee tax is $151,300 ($117,300 + $34,000), compared to $146,000 for the corporate purchase, but that calculation does not include taxation of a dividend payment to the shareholders.

There may be a significant state income tax difference, because investment credits may not be allowed to a lessor.

Accumulated Earnings Tax

The corporation's reduced income will ease concerns about the accumulated earnings tax. There is still a potential for a challenge at some point in time, but it is likely to be manageable.

Estate Tax

On the assumed death of John Brown in 2023, the corporation's value is predicted to be $9,228,379, and John's 55% ownership will result in a $5,075,608 ($9,228,379 × 55%) inclusion in his gross estate. In addition, John will own the full value of the new venture, which is projected to be $3,668,488 in 2023. This total value of John's interests in the business enterprises will be $8,744,096 ($5,075,608 + $3,668,488). John's gross estate is now $1,650,819 larger than in the corporate purchase arrangement ($8,744,096 – $7,093,277), which will result in about $577,787 ($1,650,819 × 35%) in additional estate tax.

There will still need to be difficult discussions over what assets should be left to Jim and Charlene to the detriment of the remaining heirs, and these issues will be compounded by the increased value of John's estate.

Asset Transition (Sale of Farm)

This purchase strategy offers the greatest opportunity for an increased farm basis through inheritance because John will own 100% of the new venture and the most significant value increases from the new venture will be attributable to him. In a simplified model for the sale of farm assets in 2031 with some assets in the corporation, there are two levels of tax on the gains from the sale.

Corporate Level

Brown Farms's gain and tax are reduced because it has fewer assets to sell. The computation of its $13,395,920 gain is shown in Figure 13.27. Its tax at a 40% combined federal and state rate is $5,358,368.

Figure 13.27 Brown Farms's Expected Gain

Sales price of farm interests	$14,895,920
Corporate basis in assets	
Land	(1,000,000)
Other assets	(500,000)
Corporate gain	$13,395,920

Individual Level

After Brown Farms's tax is paid, the shareholders will receive $9,537,552 (as shown in Figure 13.28) in the corporate liquidation. This is $4,292,245 ($13,829,797 – $9,537,552) less than in the scenario of the corporate purchase, but the gain from the sale of the new venture's assets is a separate transaction.

The total after-tax payout of $14,925,188 is higher than the $12,572,493 they received under the corporate purchase option.

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Figure 13.28 Shareholders' After-Tax Proceeds

Distribution ($14,895,920 – $5,358,368)	$9,537,552
Basis in stock	
All (stepped up at John's death)	(5,075,608)
Jim (original gift)	(400,000)
Charlene (original gift)	(50,000)
Gain on liquidation	$4,011,944
Shareholders' tax on gain ($4,011,944 × 20% combined rate)	$ 802,389
Net liquidating distribution to shareholders ($9,537,552 – $802,389)	$ 8,735,163
Sale of new venture property	$ 6,620,409
Basis (land plus estate step-up on improvements)	(4,468,488)
Gain on sale	$ 2,151,921
Shareholders' tax on gain ($2,151,921 × 20% combined rate)	$ 430,384
Net gain to heirs on new venture property ($6,620,409 – $430,384)	$ 6,190,025
Total after-tax cash to family ($8,735,163 + $6,190,025)	$14,925,188

Analysis of Purchase by LLC

A common tax-planning technique is to form a noncorporate family entity (such as an LLC, limited partnership, or trust) to hold real estate and improvements. The Brown Farms shareholders are considering an LLC (JJC Family LLC) that will be equally owned by John, Jim, and Charlene. They would treat the LLC as a partnership for federal income tax purposes and have it rent the property to Brown Farms.

Income Tax Effects

The income tax effects for both Brown Farms and the LLC members must be considered.

Corporate Level

Assuming the fair value rental for the new venture property is $250,000, the corporation's income would be the same as in the rental from John (previously shown in Figure 13.25), and the corporate income tax would still be about $117,300.

Individual Level

The LLC members' individual income tax returns would in the aggregate show the same income as in Figure 13.26. Each individual would report $28,333 in net income ($85,000 ÷ 3). The LLC's cash flow would also be the same as John's, except that income taxes could be somewhat lower because of the opportunity to spread the new venture income over three potentially lower tax brackets. However, there will not be a significant change in the federal income tax results.

As with John's individual ownership, there may be a significant state income tax difference, because investment credits may not be allowed to a lessor.

Accumulated Earnings Tax

The reduced income to Brown Farms will alleviate the accumulated earnings tax issue. There is still a potential for a challenge at some point in time, but it is likely to be manageable.

Estate Tax

This plan will accomplish a tremendous amount of estate tax savings compared to the first two options. John's estate will still include the corporate value of $5,075,608, but his ownership of the new venture will now be a one-third interest, or $1,222,707. This is a total $6,298,316 business enterprise value in his estate, and the gross estate is now about $2,450,000 less than if John purchased the property and about $800,000 less than if the corporation purchased the property. The predicted estate tax savings are about $860,000 and $300,000, respectively.

The family will still need to discuss how assets will be allocated to Jim and Charlene to the detriment of the remaining heirs, but these issues have been alleviated by the increased asset growth realized by Jim and Charlene.

Asset Transition (Sale of Farm)

In the corporate purchase option, Jim and Charlene's value grew by 40% and 5% of the net increase in the value of the combined farming operations until 2031. In the purchase-by-John option, their interests grew only by 40% and 5% of the original farming operation. In the LLC plan, their value has grown by 40% and 5% of the original operation and 33.3% and 33.3% of the new venture.

Figure 13.29 shows the projected asset values for Jim and Charlene in 2031.

Figure 13.29 Value of Assets in 2031

	Corporate Purchase	John Purchase	LLC Purchase
Jim	$3,178,747	$1,891,352	$2,980,836
Charlene	$ 399,843	$ 236,419	$1,325,904

In a simplified model for the sale of farm assets in 2031 with some assets in the corporation, there are two levels of tax on the gains from the sale.

Corporate Level

The corporate level gain would be the same $13,395,920 that is shown in Figure 13.27, and the combined state and federal tax at a 40% rate would still be $5,358,368.

Individual Level

The shareholders would receive the same $8,735,163 net liquidating distribution shown in Figure 13.28, but the gain on the sale of the new venture property would be higher, because John's interest in the property would be only 33.33%, so that less of the property receives a stepped-up basis. Figure 13.30 shows the changed computation.

Figure 13.30 Gain on Sale with LLC Owning New Venture

Sale of new venture	$ 6,620,409
Basis (cost plus estate step-up)	(2,022,707)
Gain on sale	$ 4,597,702
Family members' tax on gain ($4,597,702 × 20% combined rate)	$ 919,540
Net to family from new venture ($6,620,409 – $919,540)	$ 5,700,869
Total to family ($8,735,163 + $5,700,869)	$14,436,032

Analysis of Split-Interest Purchase

The first three options discussed are all fairly common business structures. Not as often used is the split-interest purchase. The fourth option assumes that Brown Farms, Inc. purchases a 15-year term (current) interest in the new venture, while JJC Family LLC purchases the remainder interest.

Definition of Parital Interests

Term Interest

A term interest allows one party to have full rights and benefits related to an underlying asset for a set period of time. At the expiration of that period of time, all rights to the property are transferred to a remainder owner, or possibly a different term or life estate owner. Term interests are also referred to as current or income holder interests.

Life Estate

A life estate is similar to a term interest in that the owner has all rights and benefits to an underlying asset, with those rights expiring at a point in the future. The significant difference is in how the period of time is measured. Instead of a specific period of time with a predetermined expiration date, the rights terminate at the death of the holder or of another individual or individuals. Life estate interests are also referred to as current or income interests. Life estates will not be discussed further in this chapter, as the planning point to be illustrated is based on a corporate term purchase.

Remainder Interest

A remainder interest in property is the ownership that completes the ownership in property with a term interest or life estate. A remainder holder has no rights to the property for either the stated term of the term interest holder or life of the life estate holder. When the term or life estate interest ends, the remainder interest holder acquires the rights to the property and becomes the full owner of the property.

Uses of Partial Interests

Common uses of split-interest ownerships include charitable purposes (charitable remainder trusts), estate reduction planning (grantor retained trusts), planning to protect assets from creditors (including Medicaid planning), as a testamentary substitute to transfer property (avoiding probate), and for other business purposes such as accelerating deductions and making corporate transfers.

The use of a split-interest ownership in an asset purchase scenario is less common, but the legal ownership of property in this example is similar to the more customary uses of split-interest ownership.

Depreciation/Amortization of Partial Interests

When unrelated parties purchase a term interest, they are generally allowed to amortize the cost of that interest over the term they hold the rights to the property.

However, if the term and remainder interest holders are related, I.R.C. § 167(e)(1) prohibits amortization of the term interest. The term holder is allowed to depreciate any property that is otherwise eligible for depreciation over its normal depreciable life without regard to any term limits. The term holder calculates depreciation using the entire basis of depreciable property, including the portion purchased by the remainder holder. At the end of the term, all available basis transfers to the remainder holder.

During its 15-year ownership term, Brown Farms will fully deduct the $200,000 cost of the purchased buildings and the $1,000,000 of additional improvements over their 10-year cost recovery life. In 2026, the LLC will receive the property with an $800,000 basis in the land and no basis in the improvements.

Value Computations of Partial Interests

Since May 1, 1989, the valuation of term interests and remainder interests are computed using the actuarial valuation tables in IRS Publication 1457, *Actuarial Valuations,* and the interest rates determined monthly under I.R.C. § 7520. A taxpayer can elect to use the I.R.C. § 7520 rate for the month of the transfer or either of the 2 preceding months.

Figure 13.31 shows the information needed to allocate the new venture purchase price.

Figure 13.31 Information for Allocating Purchase Price

Item	Amount
Purchase price	$2,000,000
Length of term interest	15 years
I.R.C. § 7520 interest rate (August 2011)	2.2%

The factor for a 15-year term interest at a 2.2% interest rate is 0.278500 [Table B in Section 3 of IRS Publication 1457], as shown in Figure 13.32. Multiplying the $2,000,000 purchase price by 0.278500 results in a $557,000 ($2,000,000 × $0.278500) value for the term interest. The $1,443,000 ($2,000,000 – $557,000) remainder of the purchase price is the value of the remainder interest.

Observation Effect of Increase in § 7520 Interest Rate

As the interest rate under I.R.C. § 7520 increases, the value of the term interest increases and the value of the remainder interest decreases.

Figure 13.32 IRS Publication 1457, Section 3 Table B (2.2%)

Years	Annuity	Income Interest	Remainder
1	0.9785	.021526	.978474
2	1.9359	.042589	.957411
3	2.8727	.063199	.936801
4	3.7893	.083365	.916635
5	4.6862	.103097	.896903
6	5.5638	.122404	.877596
7	6.4225	.141296	.858704
8	7.2627	.159780	.840220
9	8.0849	.177867	.822133
10	8.8893	.195565	.804435
11	9.6764	.212881	.787119
12	10.4466	.229825	.770175
13	11.2002	.246404	.753596
14	11.9376	.262627	.737373
15	12.6591	.278500	.721500
16	13.3650	.294031	.705969
17	14.0558	.309228	.690772
18	14.7317	.324098	.675902
19	15.3931	.338648	.661352
20	16.0402	.352884	.647116

Income Tax Effects

The income tax effects for both Brown Farms and the LLC members must be considered.

Corporate Level

This tax treatment is identical to the corporate purchase example. For federal income tax purposes, the historic income of the corporation would increase by the net income of the new venture, as shown in Figure 13.33.

Figure 13.33 Brown Farms's Estimated Annual Income

Historic income	$250,000
New venture earnings (before depreciation)	300,000
New venture depreciation	(120,000)
Total estimated annual income	$430,000

After year 10, depreciation will be fully complete for tax purposes, and the estimated taxable income will be $550,000 per year. Federal income tax would be about a 34% rate, resulting in about $146,200 of tax on $430,000 of income and about $187,000 of tax on $550,000. State income tax would likely be partially offset by investment credits.

Individual Taxation

There will be no income to the individual members of the LLC for the first 15 years; but they can deduct the investment interest on the LLC portion of the mortgage during this period (subject to the limits on deducting investment interest). In year 15, the LLC will obtain all ownership and income rights and the corporation's remaining basis in the land. At this point, the LLC will lease the property to the corporation.

In summary, for the first 15 years this plan is identical to the corporate purchase strategy, and after that it is identical to the LLC purchase strategy.

Accumulated Earnings Tax

Of all four options reviewed, this one is the most beneficial from an accumulated earnings tax standpoint. The income to the corporation will be reduced over time, and the $557,000 the corporation pays for its term interest in the new venture will reduce its accumulated earnings and profits without a taxable dividend to the shareholders.

Estate Tax

On the assumed death of John Brown in 2023, his 55% interest in the corporation and his 33.3% interest in the LLC will be included in his estate. The corporation's value will include its term interest in the new venture, which will have 3 years remaining, and the LLC's value will include the value of the remainder interest. Assuming a 2.2% I.R.C. § 7520 interest rate, the factor for a 3-year term from the table in Figure 13.32 is 0.063199. Multiplying the $3,668,448 projected FMV in 2023 (from Figure 13.21) by that factor results in a $231,845 ($3,668,488 × 0.063199) value for the term interest and the remaining $3,436,643 ($3,668,488 – $231,845) value for the remainder interest.

The total value of John's interests in the farm at the date of his death will be $6,348,671, as shown in Figure 13.34.

Figure 13.34 Value of John Brown's Interest in the Farm Assets

Entity	Amount	John's Share	Value of John's Share
Corporation			
Projected value of corporation without the new venture purchase (see Figure 13.21)	$ 9,228,379		
Value of remaining term interest in new venture	231,845		
Total value of corporation	$ 9,460,224	55%	$ 5,203,123
LLC			
Value of remainder interest in new venture	$ 3,436,643	one-third	1,145,548
Total			$ 6,348,671

Asset Transition (Sale of Farm)

The asset transition plan would be very similar to the LLC purchase structure. With some assets in the corporation, there will be two levels of tax.

Corporate Level

Figure 13.35 shows the computation of the $12,838,920 corporate gain. At a 40% combined federal and state rate, the income tax due on the gain is $5,135,568.

Figure 13.35 Brown Farms's Income Tax

Sales price of farm interests	$14,895,920
Less: Term interest paid out	(557,000)
Corporate basis in assets	
Land	(1,000,000)
Other assets	(500,000)
Corporate gain	$12,838,920

Individual Level

Figure 13.36 shows the distributions to the family from the corporation and the LLC, their gain on those distributions, their income tax on that gain, and the $14,624,343 after-tax amount for the family.

Figure 13.36 Family's After-Tax Proceeds

Distribution from corporation ($14,895,920 – $557,000 – $5,135,568)	$9,203,352
Basis in stock	
All (stepped up at John's death)	(5,203,123)
Jim (original gift)	(400,000)
Charlene (original gift)	(50,000)
Gain on liquidation	$3,550,229
Shareholders' tax on gain ($3,550,229 × 20% combined rate)	$ 710,046
Net to family from corporate distribution ($9,203,352 – $710,046)	$8,493,306
Sale of new venture ($6,620,409 + $557,000)	$7,177,409
Basis	(1,945,548)
Gain on sale	$5,231,861
LLC members' tax on gain ($5,231,861 × 20% combined rate)	$1,046,372
Net to family from new venture ($7,177,409 – $1,046,372)	$6,131,037
Total to family ($8,493,306 + $6,131,037)	$14,624,343

Summary of the Options

The total federal income taxes are similar in all four options. State income tax issues may vary among the options. The split-interest purchase is far and away the best choice for minimizing exposure to the accumulated earnings tax, and the corporate purchase option is the worst choice for that purpose. The estate tax due on John Brown's death in 2023 varies from $2,200,000 to $3,060,000, as shown in Figure 13.37. The LLC purchase or split-interest options will be the most beneficial for asset transition. The split-interest and LLC purchases both result in much more asset growth for Charlene, primarily to John's detriment.

Figure 13.37 Estate Taxes and Net Proceeds from Sale of Assets

	Business Assets Included in Estate	Estate Tax	Net Proceeds from Sale of Assets
Corporate purchase	$7,093,277	$2,500,000	$12,572,493
Majority shareholder purchase	$8,744,096	$3,060,000	$14,925,188
LLC purchase	$6,298,316	$2,200,000	$14,436,032
Split-interest purchase	$6,348,671	$2,225,000	$14,624,343

The split-interest purchase and the LLC purchase options would result in significant savings over all other methods when combining the estate tax savings with the net cash to family members on sale. In a higher-interest-rate environment, the split-interest purchase would be even more beneficial than the LLC purchase.

Other Considerations

The family should also consider the complications that may arise from split-interest ownership, such as needs for additional computations and an attorney with specialized knowledge and possible lender confusion. These may offset the advantages of a split-interest purchase.

Variations on the four options and additional options could be considered, such as:

- Use of a profits interest in the new LLC to compensate Charlene
- Use of special allocations in the LLC to provide additional income or capital to younger-generation owners
- Use of discounts in making estate tax valuations
- The potential for increased depreciation deductions in all but the corporate ownership structure from a basis adjustment after the majority owner's death
- The potential sale of either split interest during the term interest period

ISSUE 6: SCHEDULES M-1, M-2, AND M-3 (FORM 1120)

Because tax law is not congruent with generally accepted accounting principles (GAAP), the profit reported on a company's financial statements is seldom (if ever) the same as its taxable income on its federal income return.

Schedules to help both taxpayers and the IRS reconcile income and deductions are included on all business entity returns, whether the business is taxed as a partnership or a corporation. This section reviews the schedules for Form 1120, U.S. Corporation Income Tax Return, but similar information is required on Form 1065, U.S. Return of Partnership Income, and the other corporate returns in the Form 1120-series.

This section reviews Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return; Schedule M-2, Analysis of Unappropriated Retained Earnings per Books (line 25, Schedule L); and Schedule M-3 (Form 1120), Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More. Schedule L, Balance Sheets per Book, is not reviewed, but it must be completed before Schedule M-2 can be prepared.

Schedule M-3 (Form 1120) is a separate schedule, whereas Schedules L, M-1, and M-2 appear on page 5 of the paper Form 1120.

Who Must File

These schedules are optional for small corporations, but they can be helpful to shareholders and in audit preparation, if the return is selected by the IRS for examination.

- Corporations that have total receipts (line 1c plus lines 4–10 on page 1 of Form 1120) and total assets at the end of the tax year that are less than $250,000 are not required to complete Schedules L, M-1, and M-2. To skip these schedules, an eligible corporation must check the "Yes" box for question 13 on Schedule K, Other Information, and enter the total of the cash distributions and the noncash property distributions (at book value) the corporation made during the tax year. Schedule K is on page 4 of the paper Form 1120.
- Corporations with total assets of $10,000,000 or more on the last day of the tax year, as shown on Schedule L, must complete Schedule M-3 (Form 1120) instead of Schedule M-1. The $10,000,000 can be for a single corporation, but it applies to the aggregate assets of a corporate group that files consolidated return. A corporation filing Form 1120 that is not required to file Schedule M-3 (Form 1120) may voluntarily file Schedule M-3 (Form 1120) instead of Schedule M-1.

Schedule M-1

Generally, a corporation prefers to maximize the earnings shown on its financial statements within the parameters allowed by GAAP, and it seeks to minimize its taxable income for the same period within the parameters allowed by federal income tax law. For this reason, as well as the differences in the parameters, the taxable income reported for federal income tax purposes usually differs from the income shown on the corporation's books for accounting purposes.

Schedule M-1 is a reconciliation of book income to the taxable income reported before any deductions for dividends received or net operating losses (NOLs). The starting point is the corporation's book income, which is entered on line 1 of Schedule M-1. The corporation then enters its federal income tax expense or benefits per books on line 2. (Although lines 1 and 2 are not totaled on the form, their sum is the corporation's pre-tax book income.)

Practitioner Note Federal Tax Benefit

A corporation that receives a refund from a carryback enters the tax benefit as a negative amount on line 2 of Schedule M-1.

The excess of the corporation's capital losses over its capital gains is entered on line 3 as an addition to book income. The remainder of the reconciliation is divided into four categories, with two categories that increase book income and two categories that decrease it. They are as follows:

1. Income subject to tax not recorded on books: These amounts are entered on line 4 and added back to book income.
2. Expenses recorded on books not deductible for tax: These amounts are entered on line 5 and added back to book income.
3. Income recorded on books not included on return: These amounts are entered on line 7 and subtracted from book income.
4. Deductions on return not charged against book income: These amounts are entered on line 8 and subtracted from book income.

Common travel and entertainment expenses that must be added back to book income on line 5c include the following items:

- Meal and entertainment expenses that are not deductible under I.R.C. § 274(n)
- Expenses for the use of an entertainment facility
- The portion of business gifts that exceeds $25 per recipient
- An individual's expenses in excess of $2,000 for conventions on cruise ships
- Employee achievement awards that exceed $400
- The cost of entertainment tickets that exceeds face value [also subject to I.R.C. § 274(n)]
- The cost of skyboxes that exceeds the face value of non–luxury box seat tickets
- Expenses for travel as a form of education

Example 13.18 Preparation of Schedule M-1

XYZ, Inc. is a calendar-year corporation that manufactures farm equipment. Its assets shown on Schedule L are less than $10,000,000, and its 2011 net book income is $260,000. Its federal income tax provision per books for 2011 was $75,000.

XYZ's tax department identified the book/tax differences shown in Figure 13.38, and XYZ's Schedule M-1 is shown in Figure 13.39.

Figure 13.38 Book/Tax Differences

Item	Amount
Tax over book depreciation	$15,000
Tax-exempt interest	$ 2,500
Officers' life insurance	$11,000
Tax gain over book gain on sale	$ 7,500

Figure 13.39 Completed Schedule M-1

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**
Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books	260,000	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	75,000		Tax-exempt interest $ 2,500	
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):				2,500
	Gain on sale	7,500	8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		a	Depreciation $ 15,000	
a	Depreciation $		b	Charitable contributions $	
b	Charitable contributions $				
c	Travel and entertainment $				15,000
	Officers' Life Insurance	11,000	9	Add lines 7 and 8	17,500
6	Add lines 1 through 5	353,500	10	Income (page 1, line 28)—line 6 less line 9	336,000

Example 13.18 assumes a variance between the calculation of depreciation for book purposes and the calculation of depreciation for tax purposes. If depreciation is calculated on a tax basis for both book and tax purposes, a Schedule M-1 adjustment will not be necessary for the gain on sale or depreciation.

Although corporations with less than $250,000 of gross receipts **and** less than $250,000 in assets are not required to complete Schedule M-1, many practitioners recommend completing it anyway. Copies of prior-year returns then will provide a record of the adjustments that tax preparers should expect to make, and they will provide a means of verifying that all timing differences eventually reverse.

Schedule M-2

A corporation's unappropriated retained earnings balance on its financial statements is shown on line 25 of the Form 1120 Schedule L, with the beginning balance in column (b) and the year-end balance in column (d). Schedule M-2 accounts for the difference between the two Schedule L entries. The difference usually comprises net income or loss for the year, distributions of earnings (dividends), and changes in the prior-year balance that resulted from prior-period adjustments or certain changes in accounting principles.

Retained earnings are usually unappropriated, which means they are fully available for distribution to shareholders as dividends.

Example 13.19 Preparation of Schedule M-2

XYZ, Inc., from Example 13.18, recorded the net income and capital transactions shown in Figure 13.40 during 2010. The corporation's financial statements are prepared on the accrual basis. Its unappropriated retained earnings balance was $300,000 at the beginning of the year, and there were no appropriated retained earnings. XYZ's Schedule M-2 is shown in Figure 13.41.

Figure 13.40 Income and Capital Transactions

Item	Amount
Net income per books	$ 260,000
Cash dividends	$ 25,000
Prior-period adjustment	$(200,000)

Figure 13.41 Completed Schedule M-2

Schedule M-2	Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)				
1	Balance at beginning of year	300,000	5	Distributions: a Cash	25,000
2	Net income (loss) per books	260,000		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	200,000
			7	Add lines 5 and 6	225,000
4	Add lines 1, 2, and 3	560,000	8	Balance at end of year (line 4 less line 7)	335,000

Form 1120 (2011)

Corporations with less than $250,000 of gross receipts and less than $250,000 in assets are not required to complete Schedule M-2. Many practitioners recommend completing Schedule M-2 even if it is not required.

Practitioner Note Partnership Return Schedule M-2

Schedule M-2 for Form 1065 is titled Analysis of Partners' Capital Accounts. The entries for net income and other increases and distributions, and other decreases, are similar to those on Form 1120. A Form 1065 Schedule M-2 is shown in the "Income Taxation of Trusts and Estates" chapter of this book.

Schedule M-3

The IRS introduced Schedule M-3 (Form 1120) as an examination tool to increase transparency and standardize the reporting of book/tax differences. Like Schedule M-1, Schedule M-3 (Form 1120) reconciles book income to taxable income before any deductions for dividends received or NOLs. However, Schedule M-3 (Form 1120) provides substantially more detail than Schedule M-1. The more detailed reporting is required only if the corporation shows total assets valued at $10,000,000 or more on Schedule L.

Practitioner Note Schedule B (Form 1120)

A corporation or group of corporations that is required to file Schedule M-3 (Form 1120) must also file Schedule B (Form 1120), Additional Information for Schedule M-3 Filers. The parent corporation of a consolidated group files one Schedule B (Form 1120) for the entire consolidated group.

Schedule B (Form 1120) does not require numerical entries: It consists of 10 questions about the corporation's financial activities that are answered yes or no.

Preparing Part I

Part I of Schedule M-3 (Form 1120), shown in Figure 13.42, requires data that questions the source of the financial information (book income).

- Lines 1–3 ask about Securities and Exchange Commission (SEC) reporting and audited financial statements.
- Lines 4–10 request information to reconcile worldwide income to the corporation's book income that is reported on Form 1120. "Includible entities" are the entities included in a consolidated group's Form 1120 and listed on Form 851, Affiliations Schedule. "Nonincludible entities" are those whose financial information is included on line 4 of Schedule M-3 but is not included on the consolidated group's Form 1120. Unless the corporation has foreign-source income, line 4a generally will equal line 11.

- Line 12 lists the totals of the asset and liability amounts that were included and removed on lines 4–11 to provide the IRS with the relative size of the entity.

Figure 13.42 Part I of Schedule M-3 (Form 1120)

SCHEDULE M-3 (Form 1120)
Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More
▶ Attach to Form 1120 or 1120-C.
▶ See separate instructions.

OMB No. 1545-0123
2011

Draft as of 08/11/2011

Name of corporation (common parent, if consolidated return) | **Employer identification number**

Check applicable box(es): (1) ☐ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only)
(3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
☐ **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
☐ **No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.
b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
☐ **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
☐ **No.** Go to line 1c.
c Did the corporation prepare a non-tax-basis income statement for that period?
☐ **Yes.** Complete lines 2a through 11 with respect to that income statement.
☐ **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.
2a Enter the income statement period: Beginning MM/DD/YYYY Ending MM/DD/YYYY
b Has the corporation's income statement been restated for the income statement period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**
c Has the corporation's income statement been restated for any of the five income statement periods preceding the period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**
3a Is any of the corporation's voting common stock publicly traded?
☐ **Yes.**
☐ **No.** If "No," go to line 4a.
b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . . ☐☐☐☐☐
c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock . . . . ☐☐☐☐☐☐☐☐☐

Line	Description	Line	Amount
4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1 .	**4a**	
b	Indicate accounting standard used for line 4a (see instructions): (1) ☐ GAAP (2) ☐ IFRS (3) ☐ Statutory (4) ☐ Tax-basis (5) ☐ Other (specify) ________		
5a	Net income from nonincludible foreign entities (attach schedule)	**5a**	( )
b	Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount) . . .	**5b**	
6a	Net income from nonincludible U.S. entities (attach schedule)	**6a**	( )
b	Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount)	**6b**	
7a	Net income (loss) of other includible foreign disregarded entities (attach schedule)	**7a**	
b	Net income (loss) of other includible U.S. disregarded entities (attach schedule)	**7b**	
c	Net income (loss) of other includible entities (attach schedule)	**7c**	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach schedule)	**8**	
9	Adjustment to reconcile income statement period to tax year (attach schedule)	**9**	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach schedule)	**10a**	
b	Other statutory accounting adjustments to reconcile to line 11 (attach schedule)	**10b**	
c	Other adjustments to reconcile to amount on line 11 (attach schedule)	**10c**	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10 . .	**11**	

Note. Part I, line 11, must equal the amount on Part II, line 30, column (a), and Schedule M-2, line 2.

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

	Total Assets	Total Liabilities
a Included on Part I, line 4 . . . . ▶		
b Removed on Part I, line 5 . . . . ▶		
c Removed on Part I, line 6 . . . . ▶		
d Included on Part I, line 7 . . . . ▶		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. Cat. No. 37961C **Schedule M-3 (Form 1120) 2011**

Preparing Parts II and III

Parts II (income items) and III (expense/deduction items) of Schedule M-3 reconcile financial statement income to taxable income using four columns.

1. Column A shows the book income statement amount.
2. Column B lists temporary book/tax differences (such as depreciation deductions).
3. Column C lists permanent differences (tax exclusion items).
4. Column D shows the tax account amount.

Because Schedule M-3 is designed to increase transparency, the variety of line items is fairly specific in nature.

Temporary Differences

Temporary book/tax differences occur because tax laws require some items of income and expense to be recognized in different accounting periods than those that are required for book purposes. Temporary differences originate in one period and reverse or terminate in one or more later periods. The four basic categories of temporary differences are as follows:

1. Income recognized in financial statements before it is taxable
2. Income reported as taxable before it is recognized in financial statements
3. Expenses recognized in financial statements before they are deducted on the tax return
4. Expenses that are deductible on the tax return before they are recognized on financial statements

Permanent Differences

Permanent differences are adjustments that are a result of fundamental differences in financial and tax accounting rules. They arise from transactions that will not be reversed in later periods. Some common examples of permanent differences are

- certain meal and entertainment expenses;
- fines and penalties;
- political contributions;
- premiums paid for officers' life insurance; and
- federal income tax.

Figures 13.43 and 13.44 show Parts II and III of Schedule M-3 (Form 1120).

Practitioner Note Partnership Reporting

A partnership must complete Schedule M-3 (Form 1065), Net Income (Loss) Reconciliation for Certain Partnerships, if any of the following criteria apply:

1. The partnership's total assets at the end of the tax year or its adjusted total assets for the year are $10,000,000 or more.
2. The partnership's total receipts for the tax year are $35,000,000 or more.
3. A reportable entity partner (one that is required to file its own Schedule M-3) owns or is deemed to own, directly or indirectly, an interest of 50% or more in the partnership's capital, profit, or loss, on any day during the tax year.

Any partnership that files Schedule M-3 (Form 1065) must also complete and file Schedule C (Form 1065), Additional Information for Schedule M-3 Filers.

Adequate Disclosure

Rev. Proc. 2010-15, 2010-7 I.R.B. 404, provides guidance about when disclosure on Schedule M-3 alone is adequate to avoid I.R.C. § 6662 accuracy-related penalties when tax is understated. The information provided must reasonably apprise the IRS of a potential controversy concerning the tax treatment of the item. Otherwise, a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, must be used to adequately disclose the item.

An item reported on a line with a preprinted description on Schedule M-1 may represent the aggregate amount of several transactions producing that item. If a potentially controversial item involves a portion of the aggregate amount disclosed on the schedule, the IRS is not reasonably apprised of a potential controversy by the aggregate amount disclosed. (In these instances, the taxpayer must use Form 8275 or Form 8275-R regarding that portion of the item.)

Combining unlike items on Schedule M-3 is not adequate disclosure.

Taxpayers that file Schedule M-3 (Form 1120) must also complete Schedule B (Form 1120), and taxpayers that file Schedule M-3 (Form 1065) must also complete Schedule C (Form 1065). These schedules are necessary to constitute adequate disclosure.

Figure 13.43 Part II of Schedule M-3 (Form 1120)

Part II **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return** (see instructions)

Draft as Of 08/11/2011

	Income (Loss) Items (Attach schedules for lines 1 through 11)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1	Income (loss) from equity method foreign corporations				
2	Gross foreign dividends not previously taxed				
3	Subpart F, QEF, and similar income inclusions				
4	Section 78 gross-up				
5	Gross foreign distributions previously taxed				
6	Income (loss) from equity method U.S. corporations				
7	U.S. dividends not eliminated in tax consolidation				
8	Minority interest for includible corporations				
9	Income (loss) from U.S. partnerships				
10	Income (loss) from foreign partnerships				
11	Income (loss) from other pass-through entities				
12	Items relating to reportable transactions (attach details)				
13	Interest income (attach Form 8916-A)				
14	Total accrual to cash adjustment				
15	Hedging transactions				
16	Mark-to-market income (loss)				
17	Cost of goods sold (attach Form 8916-A)	( )			( )
18	Sale versus lease (for sellers and/or lessors)				
19	Section 481(a) adjustments				
20	Unearned/deferred revenue				
21	Income recognition from long-term contracts				
22	Original issue discount and other imputed interest				
23a	Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b	Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c	Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d	Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e	Abandonment losses				
f	Worthless stock losses (attach details)				
g	Other gain/loss on disposition of assets other than inventory				
24	Capital loss limitation and carryforward used				
25	Other income (loss) items with differences (attach schedule)				
26	**Total income (loss) items.** Combine lines 1 through 25				
27	**Total expense/deduction items** (from Part III, line 38)				
28	Other items with no differences				
29a	Mixed groups, see instructions. All others, combine lines 26 through 28				
b	PC insurance subgroup reconciliation totals				
c	Life insurance subgroup reconciliation totals				
30	**Reconciliation totals.** Combine lines 29a through 29c				

Note. Line 30, column (a), must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Schedule M-3 (Form 1120) 2011

Figure 13.44 Part III of Schedule M-3 (Form 1120)

Part III **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items** (see instructions)

Draft as of 08/11/2011

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense				
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (attach Form 8916-A)				
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property				
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Section 198 environmental remediation costs				
30 Depletion				
31 Depreciation				
32 Bad debt expense				
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs				
36 Section 118 exclusion (attach schedule)				
37 Other expense/deduction items with differences (attach schedule)				
38 **Total expense/deduction items.** Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive				

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