

**MSCPA FEDERAL TAX COMMITTEE  
FEDERAL TAX FORUM  
S CORPORATIONS By Lorraine A. Travers**

- I. **Rescission of Sale that Terminates S Election Was Effective & Election Continued Uninterrupted—PLR 200533002**
- Sale of newly issued convertible preferred stock to three limited partnerships terminated S election but because of disagreement between S shareholders and partnership members, the transaction was unwounded in same year and IRS determined S election was not rescinded.
- II. **IRS Notice 2005-91—Interim Guidance for S Corporation Family Shareholder Election**
- Family shareholder election under new §1361(c)(1)(D) treating family members as a single shareholder.
- III. **Revaluation of Inventories to Correct Accountant's Error was Accounting Method Change—Huffman v. Commr., 126 T.C. No. 17 (5/16/06)**
- H Group of Corporations consisted of 4 S corporation members that had elected to use the link-chain, dollar-value, last-in, first-out (LIFO) inventory method. Accountant omitted a computational step required by Regs. §1.472-8. Error resulted in an understatement of the year-end LIFO value and an understatement of income from sales.
- IV. **Tax Increase Prevention & Reconciliation Act of 2005**
- Section 199 wages for S Corporations—Act repeals special limit on wages treated as allocated to S Corporation shareholders.
- V. **Corporate Resolution Allows Shareholders to Deduct Expenses—Craft v. Commr., T.C. Memo 2005-197 (8/15/05)**
- Corporate expenses paid by S shareholder were reported on his Schedule C (vehicle and related depreciation, office supplies, dues & subscriptions, P.O. box rental, & legal & professional fees). Corporate resolution required President & Vice-President to incur expenses as may be necessary or required which would not be reimbursable.
- VI. **Open Account Debt Shields S Corporation Shareholder from Income Recognition—Fleming v. Commr., T.C. Memo 2005-204 (8/25/05)**
- Shareholder advanced money to the company on open account on three occasions. Tax Court indicated payments in excess of loan basis

**MSCPA FEDERAL TAX COMMITTEE  
FEDERAL TAX FORUM  
S CORPORATIONS By Lorraine A. Travers**

were not income if at end of year there was sufficient basis to cover the payments because the loans were made on an open account.

**VII. Circular Loans Did not Increase S Shareholder Basis—Kaplan v. Commr., T.C. Memo 2005-218 (9/20/05)**

- Shareholder borrowed from bank and made loan to one of his S corporations to create basis to deduct losses. Loan proceeds received by 1<sup>st</sup> Corporation were then paid to two other S Corporations that in turn paid the proceeds to the taxpayer who then paid off his loan to the bank. Tax Court held no economic outlay.

**VIII. S Corporation Liable for Tax Preparer Penalty—CCM 200542034**

- The penalty is assessed against an S Corporation (tax preparation company) if the corporation's sole shareholder/owner is an employee under common law rules, but, if not an employee, the penalty should be assessed against the shareholder directly.

**IX. Ignoring Loan Formalities Costs Shareholders to Lose Ability to Deduct Losses—Ruckriegel v. Commr., T.C. Memo 2006-78 (4/18/06)**

- Loans made by a related partnership on behalf of two shareholders did not increase basis. Had certain formalities been observed with respect to accounting entries and such, basis would have been allowed for taking losses.

**X. Loan Restructuring Provides S Shareholder with Additional Basis—Miller v. Commr., T.C. Memo 2006-125 (6/15/06)**

- Initial loan was a revolving line between bank and corporation (shareholder as a guarantor). Losses continued despite infusion of cash. Loan restructured—bank gave shareholder personal revolving line of credit on a full recourse basis. The new loan replaced the corporate line of credit. The shareholder loan(s) to corporation and bank loans to shareholder had same interest rate and terms as original loan between bank and corporation. Tax Court asserted economic outlay and allowed loans from shareholder to increase his basis.

**MSCPA FEDERAL TAX COMMITTEE  
FEDERAL TAX FORUM  
S CORPORATIONS  
By: Lorraine A. Travers**

**I. Rescission of Sale that Terminates S Election Was Effective & Election Continued Uninterrupted—PLR 200533002**

- The IRS waived the termination of an S election because an agreement rescinding the transaction that terminated the election put the parties back in their original positions and was effective in the year of the transaction.
- An S Corporation sold shares of newly issued convertible preferred stock to three limited partnerships. The sale terminated the S election. Because of disagreements between the shareholders and the partnerships, the parties decided to unwind the partnerships' purchase of the preferred stock. The parties entered into a stock rescission agreement, which they consummated in the year of sale. The IRS ruled that the corporation would be treated as an S Corporation during the period between the date of issuance and the date of rescission. Citing Rev. Rul. 80-58, 1980-1 C.B. 181, the IRS explained that two conditions must be met for the remedy of rescission to apply: (1) the parties to the transaction must be restored to the relative positions that they would have occupied had no contract been made; and (2) the restoration must be made within the taxable year of the transaction.

**II. IRS Notice 2005-91—Interim Guidance for S Corporation Family Shareholder Election**

- IRS plans to issue future guidance regarding the S Corporation family shareholder election under new §1361(c)(1)(D). The election allows members of a family to be treated as a single S corporation shareholder for purposes of determining number of shareholders of the corporation for taxable years after 12/31/04. The election may be made by any member of the family and does not affect the requirement that an S corporation election must be consented to by all shareholders. The election will be effective from inception as an S corporation and will remain in effect until terminated as provided in future regulations. The notice also provides that an election can be made by a family member shareholder by notifying the corporation to which the election applies and identifying the member of the family making the election, the common ancestor of the family to which the election applies, and the first taxable year of the corporation for which the election is effective.

**MSCPA FEDERAL TAX COMMITTEE  
FEDERAL TAX FORUM  
S CORPORATIONS**

**III. Revaluation of Inventories to Correct Accountant's Error was Accounting Method Change—Huffman v. Commr., 126 T.C. No. 17 (5/16/06)**

- Tax Court holds that the revaluation of a corporation's inventories to correct their accountant's errors constituted a change in method of accounting. A group of corporations consisted of four S corporation members that had filed an election to use the link-chain, dollar-value, last-in, first-out (LIFO) inventory method. The members later discovered that their accountant omitted a computational step required by Regs. §1.472-8. The error resulted in an understatement of the year-end LIFO value and an understatement of income.
- The IRS corrected the error and the members of the group accepted the IRS' adjustments to the inventories for all of the years in issue, but did not accept the IRS position that by making those adjustments for the first year in issue, the accountant implemented a change to the members' method of accounting, which the IRS necessitated making additional adjustments for those years pursuant to §481(a), as in effect for the years in issue. The members argued that the adjustments were merely the correction of a mathematical error.
- The Tax Court held that the error in applying the link-chain method was an error in timing that constituted a change in method of accounting, rather than a correction of a mathematical or posting error, and, therefore, for the first year in issue, the IRS' revaluation of the members' inventory required adjustments pursuant to §481. By consistently repeating the same error, the accountant established a pattern which is indicative of a method of accounting. The Tax Court took the position that a mathematical error is generally an error in arithmetic.

**IV. Tax Increase Prevention & Reconciliation Act of 2005**

- Extends for two years the increased amount allowed to be deducted under §179 (to 2009).
- §199--The Act modifies the definition of W-2 wages, limiting qualified wages to only amounts that are properly allocable to domestic production gross receipts. Thus, the amount of the deduction is limited to 50% of only those wages that are deducted in arriving at qualified production activities. The Act also repeals the special limit on wages treated as allocated to partners or shareholders of pass-thru entities. An S shareholder or a partner who is allocated components of qualified production activities income will be treated as having W-2 wages from the pass-thru entity in an amount equal to that person's allocable share of the pass-thru entity's wages, even if that amount is

**MSCPA FEDERAL TAX COMMITTEE  
FEDERAL TAX FORUM  
S CORPORATIONS  
By: Lorraine A. Travers**

more than twice the QPAI that actually is allocated to that person. The shareholder/partner will then include in the wage limitation only the wages that are deducted in calculating QPAI.

**V. Corporate Resolution Allows Shareholders to Deduct Expenses—  
Craft v. Commr., T.C. Memo 2005-197 (8/15/05)**

- A Corporate resolution that required the shareholder to pay certain expenses was crucial in determining whether the expenses were those of the shareholder and not the corporation.
- There were two 50% shareholders who were officers/employees of the corporation. One of them deducted \$17,000 of business expenses on a Schedule C for vehicle and related depreciation expenses, office supplies, dues & subscriptions, p.o. box rental, and legal and professional fees. The Corporation had adopted a resolution requiring the two shareholder/employees as President and Vice-president to incur expenses as may be necessary or required and stating that they would not be reimbursed for these expenses. The resolution stated that the President was responsible for supplying office space and his own vehicle.
- The IRS denied the deductions stating that they were the corporation's expenses or if they were allowed should be subject to the 2% limitation.
- The first issue addressed by the Tax Court was whether the expenses were properly deductible by the taxpayer or whether they were expenses of the corporation. Voluntary payments are not deductible; however, the Tax Court held that a corporate resolution or policy, requiring a corporate officer to assume certain expenses indicates that those expenses are his expenses and not the corporation's.
- Secondly, the Tax Court had to address the issue of whether the President incurred the expenses as an employee or shareholder. §162(a) allows a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business. The performance of services as an employee constitutes a trade or business. Therefore, the expenses incurred by the shareholder/employee were deductible. However, the Court concluded that as an employee the expenses belonged on Schedule A and were subject to the 2% limitation.

**VI. Open Account Debt Shields S Corporation Shareholder from Income Recognition—Fleming v. Commr., T.C. Memo 2005-204 (8/25/05)**

- Because repayments on shareholder loans by an S Corporation were made on open account debt rather than separate debt, shareholder

**MSCPA FEDERAL TAX COMMITTEE  
FEDERAL TAX FORUM  
S CORPORATIONS  
By: Lorraine A. Travers**

loans made later in the year were netted against earlier repayments thus preventing the recognition of income as a result of the debt repayment.

- Two shareholders had advanced money to their S Corporation over three years on open account—in 1997, 1999 and 2000. At the end of 1998, the amount owed to them was \$1 million but had a zero tax basis due to losses in 1997 and 1998. At the end of 1999, they had made advances totaling \$1.6 million covering the repayment of \$1 million earlier during the year and the year end loss. At the end of 2000, they made advances totaling \$2.2 million to cover the earlier repayment of \$1.6 million and the year end loss.
- Generally, S Corporation shareholders may not offset the repayment of a shareholder advance with the basis of another separate shareholder advance. However, multiple shareholder advances and repayments that constitute an open account indebtedness are treated as a single debt rather than separate debt. The IRS agreed that the advances and the repayments constituted an open account and not separate debt. However, the IRS argued that the shareholders must recognize income on the repayment of their advances to the extent the repayment exceed their basis in the advance on the date of repayment.
- The Tax Court held otherwise, stating that the basis of an open account debt is properly computed by netting at the close of the year advances of open account debt during the year and repayments of open account debt during the year. The IRS had argued that under **Cornelius v. Commr.**, 494 F.2d 465 (5<sup>th</sup> Cir. 1974) the shareholders must recognize income. However, the Tax Court pointed out that in that Case the debt was not on open account but separate debt.

**VII. Circular Loans Did not Increase S Shareholder Basis—Kaplan v. Commr., T.C. Memo 2005-218 (9/20/05)**

- Taxpayer had several S Corporations. In one of the Corporations he had a substantial loss but no basis to deduct the loss. At the end of the following year he borrowed \$800,000 from a bank which he lent to this corporation. This corporation in turn wrote checks for \$550,000 and \$250,000 payable to two S Corps owned by taxpayer. When they received the money, these two corporations paid the taxpayer a like amount which he then used to pay off his bank loan. The entire process took eleven days. Subsequently, the 3 corporations merged into another corporation, a C Corporation wholly-owned by the taxpayer.
- In 1997, the taxpayer reported a net loss of \$608,858 from the first corporation which included the income from 1997 and the carryover

**MSCPA FEDERAL TAX COMMITTEE**  
**FEDERAL TAX FORUM**  
**S CORPORATIONS**  
**By: Lorraine A. Travers**

loss from 1996. He reported a net operating loss on his return and carried it back to 1994.

- The IRS disallowed the 1996 loss stating that the loss exceeded his basis in his stock and debt for 1997. Taxpayer petitioned the Tax Court. Taxpayer argued that one of the payments (\$250,000) to a second corporation was not part of a circular arrangement as the first corporation owed that corporation \$204,222. The Tax Court held that Mark failed to establish his increased basis in the loss corporation because he had made no “economic outlay”. The fact that the money ended up in separate accounts belonging to two other corporations was no significant risk to either the bank or the taxpayer and since taxpayer controlled all 3 corporations, there was no risk that they would act adversely. Finally, the merger of all 3 into a new C Corp. meant that all loan obligations between him and his S Corporations were extinguished. Also, the Court stated there was no substance to the transaction.

**VIII. S Corporation Liable for Tax Preparer Penalty—CCM 200542034**

- An S Corporation was in the tax return preparation business and its sole shareholder was an employee. The Corp. had another employee. No wages were paid to the shareholder just to the other employee. Both employees signed returns but the shareholder signed the bulk of the returns. One-half of the returns prepared by the shareholder were prepared using the name and employer i.d. of the corporation and the other half only her name and social security number. On audit, the shareholder refused to submit a list and copies of returns. The IRS assessed penalties under §6695 for failing to provide the IRS with the list of clients as required by §6107(b).
- The question arose as to who was responsible for the penalties. The Office of Chief Counsel advised that the penalty should be assessed directly against the S Corporation if the sole shareholder/owner is considered an employee of the corporation under common law rules. Because there was another employee, the corporation was considered a return preparer and if the facts indicate that there is an employer-employee relationship between the S Corp. and the shareholder, then with respect to the returns signed under the corporate name and i.d., the penalty should be assessed against the corporation.

**MSCPA FEDERAL TAX COMMITTEE**  
**FEDERAL TAX FORUM**  
**S CORPORATIONS**  
**By: Lorraine A. Travers**

**IX. Ignoring Loan Formalities Costs Shareholders to Lose Ability to Deduct Losses—Ruckriegel v. Commr., T.C. Memo 2006-78 (4/18/06)**

- Two shareholders were denied an increase in their S stock basis for loans made through them to their S corporation by a related partnership. According to the Tax Court had certain formalities been observed with respect to accounting entries and other items, the deductions would have been allowed.
- Two brothers were 50% owners of an S corporation that operated approximately 50 franchise restaurants. From inception in 1993 through 2000, the corporation operated at a loss. The brothers were also 50% partners in a general partnership that owned and leased real property. This entity operated at a profit.
- The IRS audited their personal 1995 and 1996 returns and disallowed the S corporate losses taken because of lack of basis. After the audit, their CPA spoke to the IRS on the proper way to structure future loans so that the shareholders could have basis for their losses. In 1997-2000, the CPA advised them how to structure the loans to achieve basis. The agent that audited their 1997 and 1998 returns did not challenge the losses taken by the brothers.
- From 1997-2000, the partnership transferred funds directly or indirectly (wire transfer) to the S Corp. Only one payment was made to the brothers first and then to the corporation. In all, \$6 million of loans was made. For two of the payments, no adjusting entry was made on the partnership's books to recharacterize the loans as to the brothers first and then as coming from the brothers on the corporate books. During 1997-2000, the brothers executed promissory notes to the partnership and the corporation executed promissory notes to the brothers. Some of the promissory notes predated the transactions to which they related. There were minutes executed for each promissory note at the corporate and partnership level authorizing the loans. None of the minutes were drafted and executed earlier than June 2000.
- The IRS disallowed the brothers' deductions for 1999 and 2000 claiming the brothers had zero basis and that they failed to satisfy the economic outlay requirement. The brothers quoted some cases to support their position whereby other entities made loans on their behalf to acquire basis; e.g., *Culnen v. Commr.* & *Yates v. Commr.*
- The Tax Court rejected the IRS' view of the economic outlay requirement as only being met if the taxpayer invests in or lends to the S corporation his own funds, or funds borrowed from an unrelated party, to whom the shareholder is personally liable. The Court also noted that even though the partnership borrowed money to fund the corporate

**MSCPA FEDERAL TAX COMMITTEE  
FEDERAL TAX FORUM  
S CORPORATIONS  
By: Lorraine A. Travers**

credit. On the same day the S/H extended a \$1 million revolving line of credit to the S corporation. The amount drawn down on the personal line was lent to the corporation who in turn paid off its outstanding balance to the bank. Both loans were due on 12/31/93 and carried the same interest rate and terms as the original loan from the bank to the corporation. In 1993 and 1994, the lines of credit for both loans were increased, but, the terms and conditions remained the same. All loans were fully documented. Taxpayer took losses in 1992-1994 but the IRS disallowed them.

- Taxpayer held that courts have allowed the losses where there is an actual economic outlay that leaves the taxpayer “poorer in a material sense”. Courts have held that the presence of a third-party lender as a source of the funds lent constitutes an economic outlay. The IRS disagreed and argued that despite the loan restructuring, the relationship between the corporation, the bank and the shareholder remained the same. The Tax Court disagreed and said that the shareholder made an economic outlay which left him poorer in a material sense because he was the fully recourse obligor on enforceable debt held by an independent, third-party lender.

**XI. IRS Notice 2006-52—Refund of Excise Taxes Paid on Long-distance Telephone Services**

1. Refunds will be available to all taxpayers on their 2006 returns for excise taxes paid on long-distance telephone services incurred in 2003 to 2006. The refund will be based on actual taxes billed after 2/28/03 and before 8/1/06 for businesses. The safe harbor amount proposed will be allowed for individual returns only; business returns will be refunded only for actual amounts billed.

**XII. New Tax Credits under EPA 2005, effective for 2006.**

- New qualified alternative motor vehicle credit (Notice 2006-54 & also GOZA 2005)
- New qualified fuel cell motor vehicle credit for vehicles placed in service after 2005 through 2014
- Credit for electricity produced from renewable sources
- Nonconventional source fuels credit
- New advanced lean burn technology motor vehicle credit for vehicles placed in service after 2005 through 2010
- Qualified hybrid motor vehicle credit for vehicles placed in service after 2005 through 2009
- Credit for pollution control facilities