

**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shareholders and partnership members, the transaction was unwounded in same year and IRS determined S election was not rescinded.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 1st 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

