

# **PATENTAX® TALK**

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## **TRENCH WARFARE – MANEUVERING THROUGH THE FRONTLINES OF S CORPORATIONS**

**PRESENTED BY:**

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The following presentation materials should not be construed as representing advice on specific legal matters, but rather as general commentary on the subjects discussed. Your questions and comments are always welcome.

## **BACKGROUND OF SPEAKER**

### **LAYTON L. PACE**

Layton Pace has practiced law for over 20 years in Beverly Hills and the South Bay of Los Angeles. His practice focuses on federal and California income and franchise taxation of limited liability companies, C corporations, S corporations and individuals engaged in a wide spectrum of business and real estate-related activities and California sales and use tax, property tax and other business tax issues. His practice splits between transactional tax planning and handling tax controversies.

Mr. Pace speaks frequently and writes on various real property, limited liability company, partnership and other federal and California tax-related topics. Mr. Pace is a past member of the Executive Committee of the Taxation Section of the California State Bar and was honored by them at their annual meeting in November 2008 by receiving the V. Judson Klein Award. He also is a past chair of that organization's Business Entities Committee and of the Business Entities Committee of the Taxation Section of the Los Angeles County Bar Association.

Mr. Pace graduated cum laude from UC Hastings College of Law in San Francisco, California in 1987. He received an undergraduate degree in Business Administration (accounting concentration) from the University of Washington in Seattle, Washington in 1980.

# EXAMPLE 1A

## LOANS FROM SHAREHOLDERS

### Basic Facts:

US citizens, A and B, each own 50% of the common stock of **S Corp.**, a California corporation, that has been an S corporation since January 1, 2003, after being a C corporation in 2001 and 2002 when it accumulated significant earnings and profits. S Corp. owes each of A and B \$100,000, which they loaned in cash to S Corp. in three advances, \$20,000 in 2005, \$40,000 in 2007 and initially \$60,000 in 2009 of which \$20,000 was paid back by the end of that year (the “**Shareholder Loans**”). S Corp. did not issue notes or other written evidences of indebtedness for the Shareholder Loans. In 2009, S Corp. suffered losses, which eliminated all of the tax basis in the S Corp. shares of A and B and caused a collective reduction of the basis in the Shareholder Loans of \$40,000 for each of A and B. S Corp. has a negative \$80,000 accumulated adjustments account (AAA) at the end of 2009.

In 2010, S Corp. generated \$100,000 in income items from operations and \$80,000 in business expense items. Also in 2010, S Corp. paid \$30,000 in cash to each of A and B in addition to interest on the Shareholder Loans.

### Variations:

If A and B each paid in \$40,000 to S Corp. at the end of 2010 what would be the treatment if the \$40,000 is a loan? A capital contribution?

What result if S Corp. paid all of the \$40,000 to A on his Shareholder Loan because he needed the money and B did not?

### Issues Raised:

What are the S Corp. debts to A and B at the end of 2009? What are the tax bases in the Shareholder Loans after the 2009 losses?

What are the tax consequences if the \$30,000 paid by S Corp. in 2010 is treated as a repayment of the Shareholder Loans? Any difference if S Corp specifically identifies the Shareholder Loans made in 2007 as the loans paid? What differences if S Corp. had issued promissory notes? What are the tax consequences in 2010 if the \$30,000 paid by S Corp. in 2010 is treated as a distribution with respect to the shares of S Corp.?

Do capital contributions restore the tax basis of the Shareholder Loans? One-class-of-stock issues?

### Authorities:

Treas. Reg. § 1.1367-1 – New open account debt rules effective Oct. 17, 2008

Treas. Reg. § 1.1367-1 & -2 -- Ordering of debt and stock basis restoration

IRC Section 1368 – Distributions of E&P with 2010 dividend rates

IRC Section 1271; Rev. Ruls. 64-162 and 68-537 -- Repayment of debts with tax basis below face

Treas. Reg. § 1.1361-1(l) -- Straight debt and proportional debt safe-harbors

Nathel v. Comm’r, 105 AFTR 2d 2699 (2<sup>nd</sup> Cir. 6/2/10) (effect of capital contributions to corp.)

## EXAMPLE 1B

### CAPITAL CONTRIBUTIONS BY SHAREHOLDERS

#### **Basic Facts:**

Same facts as in Example 1A, except that to bolster the net worth of S Corp. so it could obtain a bank loan, A and B each contributed the Shareholders Loans to S Corp. at the beginning of 2010 as a contribution of capital.

#### **Variations:**

Any differences if S Corp. actually issues shares of stock to A and B?

Instead of contributing the Shareholder Loans, A and B each contribute a 50% tenants-in-common interest in real property to S Corp. that has a fair market value in excess of their respective tax bases in the property.

#### **Issued Raised:**

Does S Corp. have cancellation of indebtedness (COD) income?

Are A and B treated as exchanging the Shareholder Loans in a taxable transaction, and if so, can they claim a loss?

What basis does S Corp. have in the contributed assets?

#### **Authorities:**

IRC Section 108(e)(6) treatment

IRC Section 108(d)(7) rules for basis of S corp. debt

IRC Section 351(d)

IRC Section 362(e)

## EXAMPLE 1C

### LOAN FROM BANK

#### **Basic Facts:**

Same facts as in Example 1A, except that S Corp. borrowed \$300,000 from a bank (the “**Bank Loan**”) in 2008 at an interest rate above AFR, the principal of which is still outstanding and due at the end of 2010. Each of A and B have guaranteed the Bank Loan.

#### **Variations:**

Instead of S Corp. borrowing the money directly from the bank, A and B borrow the money from the bank and they loan the \$300,000 to S Corp.

Same as the last variation except that A and B borrow the money from a limited liability company of which each owns 50%, rather than from the bank.

By the end of 2010, S Corp. cannot pay the bank in full and bank agrees to accept \$200,000 in cash to sell or retire the Bank Loan in full. Assume S Corp. pays the \$200,000. Assume A and B buy the Bank Loan from the bank and soon thereafter agree to extend the maturity date by 10 years.

#### **Issues Raised:**

Can A and B claim losses incurred by S Corp. because of the Bank Loan? If A or B make payments on the guarantee?

Is a loan first made by a related party a shareholder loan for purposes of passing through losses from S Corp.?

Can S Corp., A or B exclude or defer gain when \$200,000 satisfies \$300,000 of liability? How?

Do A and B have gain from the modification of the acquired Bank Loan?

#### **Authorities:**

Cases regarding no stock basis for guaranteed debt until economic outlay

Russell v. Comm’r, 106 AFTR 2d 5243 (8<sup>th</sup> Cir 8/27/10) (loan to corp. from related party)

Unreleased regulations project for back-to-back loans

IRC Section 108(i) relief for 2010 and differences for A and B

Treas. Reg. § 1.1001-3 substantial modifications

## EXAMPLE 2A

### SALE OF S CORP STOCK

#### **Basic Facts:**

US citizens, A and B, each own 50% of the common stock of **S Corp.**, a California corporation that has been an S corporation since January 1, 2003 after being a C corporation in 2001 and 2002 and has acquired no assets in tax-free transactions with other C or S corporations. S Corp. has developed key software in the United States for a very popular mobile phone and is doing very well in 2010 so it holds significant cash and both its intangible assets and its shares are highly appreciated. An unrelated C corporation (“**Buyer**”) has offered to buy in 2010 all of the S Corp. shares held by A and B.

#### **Variations:**

The sale occurs in 2011.

#### **Issued Raised:**

Is all of the gain capital gain?

What are the tax rates?

#### **Authorities:**

No collapsible corporation rules under IRC Section 341 in 2010  
Higher capital gains rates in 2011

## EXAMPLE 2B

### SECTION 338(h)(10) ELECTION

#### Basic Facts:

Same facts as in example 2A, except that Buyer (an unrelated C corporation) has decided that it wants a tax basis step up in the assets of S Corp. from the purchase and S Corp. has non-assignable key contracts that make an asset sale not feasible. Therefore, A and B and Buyer decide to complete the stock sale and make an IRC Section 338(h)(10) election.

#### Variations:

A has reservations about selling his shares, so Buyer agrees to pay him more for his shares than to B.

Buyer wants to pay a substantial portion of the purchase price in installments in years after 2010.

#### Issues Raised:

What additional tax costs do A and B face from the IRC Section 338(h)(10) election?

Does the larger amount paid to A jeopardize the S status of S Corp. because of the one-class-of-stock rules?

Does the installment sale accelerate gain or increase the tax costs?

#### Authorities:

IRC Section 1374 – 7-year recognition period for sales in 2009 and 2010; 5-year period starting in 2011.

Character differences from asset vs. stock sale

Treas. Reg. 1.1361-1(i) – One class of stock exception for differing amount paid to A

Sales tax avoidance

Different state tax sourcing from stock sale

IRC Section 453B(h) rules re S corp. installment sales and 12 month liquidations

California 1.5% S corporation tax on liquidations involving installment obligations