S CORPORATION UPDATE

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1. RECENT DEVELOPMENTS

1.1 Section 199A[2]

1.1(a) Final regs

◊ The activity of leasing real estate to a pass-through entity controlled by the owner(s) of the real estate will be treated as a Section 162 business for Section 199A purposes. Same for a license of intellectual property to a commonly controlled entity.[3]

1.1(b) Notice 2019-7 with real estate safe harbor

◊ AICPA comments on the regs and the safe harbor:

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[1] *This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

This outline was completed on September 2, 2019 and does not reflect developments after that date.

[2] See SECTION 199A UPDATE,-- WITH CASE STUDIES at http://www.staleylaw.com/images/Section_199A_Update_with_Case_Studies_84649xA938A_.PDF.

[3] Treas. Reg. § 1.199A-1(b)(14).

- For the leasing/licensing rule, it should not make any difference whether the lessee/licensee is a C corporation or a pass-through entity.[4]

- Separating commercial and residential property would be a problem for mixed-use properties.

- The 250-hour threshold should be to 100 hours.

- Documenting those hours "is unduly burdensome to the taxpayer as well as the taxpayer's agents and independent contractors."

◊ The New York State Bar Association's Tax Section said the distinction between residential and commercial real estate is "ill-defined" and the 250-hour requirement is an inadequate measure of businesses' activities.[5]

◊ The IRS plans to flesh out the definition of a triple-net lease, but does not otherwise expect the revenue procedure to vary much from the Notice.[6]

1.1(c) Who benefits from Section 199A?

◊ The majority of the beneficiaries of the [Section 199A] deduction are in the bottom 80 percent of the income distribution.

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[4] AICPA, *Guidance Concerning the Deduction for Qualified Business Income Under Section 199A of the Internal Revenue Code*, April 9, 2019, https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20190409-aicpa-comments-on-199a-safe-harbor-final-regs.pdf.

[5] L. O'Neal, *Call for Real Estate-Friendly Rules Unlikely to Sway Treasury*, Daily Tax Report (BNA), May 15, 2019.

[6] *Id.*

◊ However, 60 percent of pass-through income, and 72 percent of the statutory benefit of the pass-through deduction, accrues to taxpayers in the top five percent of adjusted gross income (above roughly $208,000) [for 2018].

◊ Without the 199A guardrails, we estimate that this group would receive 83 percent of the statutory benefit.[7]

◊ The rules and regulations of Section 199A establish guardrails that limit who may benefit from the deduction.

- Two limitations begin phasing in at $315,000 in taxable income for married taxpayers ($157,500 for unmarried) [for 2018]….

- For taxpayers with incomes above the top of the phase-in range, the guardrails eliminate the portion of the 199A deduction derived from businesses that either are "specified service trades or businesses" (SSTBs) or do not pay sufficient W-2 wages or own enough capital assets[8]

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[7] L. Goodman, K. Lim, B. Sacerdote, A. Whitten, SIMULATING THE 199A DEDUCTION FOR PASS-THROUGH OWNERS, U.S. Department of the Treasury, Office of Tax Analysis, May 2019 (Summary preceding page 1).

[8] *Id.* at page 1.

1.2 S Corporations

1.2(a) The AAA and the PTTP

- ◊ Does a distribution in the Post Termination Transition Period (the "PTTP") reduce the corporation's accumulated adjustments account ("AAA")? Well, yeah.[9]

- ◊ Otherwise the 2017 provision allowing tax-free distributions of AAA after the PTTP would full or partial allow tax-free distributions forever.[10]

1.2(b) Parent terminates S election and cash method QSub becomes a C corporation

- ◊ The 2017 Tax Act allowed a six-year adjustment period if a cash method corporation terminated its S corporation election within two years after the Act and kept the same shareholders.[11]

- ◊ The AICPA noted that no adjustment period is available for a cash method QSub if it becomes a C corporation as a result of the termination of its parent's S corporation election.[12]

- ◊ The AICPA asked for administrative guidance on the issue.

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[9] Rev. Rul. 2019-13, 2019-20 I.R.B. 1. The Code does not say this, but it makes sense.

[10] I.R.C. § 1371(f), added by the 2017 Tax Act.

[11] I.R.C. § 481(d).

[12] AICPA, *Guidance Concerning Adjustments Attributable to Conversions from S Corporation to C Corporation under Section 481(d) of the Internal Revenue Code*, August 14, 2019, Tax Notes Document Service, Document 019-31604.

◊ Until the IRS responds, the S parent in this situation might consider converting the QSub into an single-member LLC, so that the six-year adjustment period will be available to the parent after it terminates its S corporation election.

◊ Note that the 2017 Tax Act increased from $5M to $25M the gross receipts of a C corporation without inventory that could use the cash method.[13] Qualified personal service corporations are also allowed to use the cash method.[14]

1.2(c) **Electing Small Business Trusts with Nonresident Aliens as Potential Current Beneficiaries**

◊ The 2017 Tax Act allowed an NRA to be a PCB of an ESBT.[15]

◊ Proposed regs were issued in June.[16]

◊ If an NRA is a deemed owner of a grantor trust that has elected to be an ESBT, the proposed regs would assure that the S corporation income of the ESBT would continue to be subject to U.S. federal income tax.

◊ The proposed regs would modify the allocation rules under §1.641(c)-1 to require that the S corporation income of the ESBT must be included in the S portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules.

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13 I.R.C. § 448(b)(3), (c).

14 I.R.C. § 448(b)(2), (d)(2).

15 I.R.C. § 1361(c)(2)(B)(v).

16 84 Fed. Reg. 28214 (6-18-19), amending Treas. Reg. § 1. 1.641(c)-1.

◊ That income would be taxed to the domestic ESBT by providing that, if the deemed owner is an NRA, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT's S portion.

1.2(d) **Value of S Corp Stock**

◊ A federal district court in Wisconsin accepted a value for an S corporation that included hypothetical C corporation taxes at the entity level.[17]

◊ The Tax Court and the Sixth Circuit rejected this approach in 1999 and 2001.[18] But a recent Tax Court Memorandum decision suggests that the Tax Court might again accept

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[17] Kress v. U.S., 2019-1 U.S.T.C. ¶ 60,711, (E.D. Wisconsin, Mar. 26, 2019):

> [The appraisal accepted by the Court] applied C-corporation level taxes to [the subject S corporation's] earnings to effectively compare [it] to the other C-corporations. [The IRS expert, whose approach the Court did not accept] then assessed a premium to account for the tax advantages associated with subchapter S status, such as the elimination of a level of taxes, and noted [that the S corporation] did not pay C-corporation taxes in any of the valuation years and did not expect to pay those taxes in the future. [The appraisal accepted by the Court] did not consider … subchapter S status to be a benefit that would add value to a minority shareholder's stock because a minority shareholder cannot change [the S corporation] status. The court finds [the subject corporation's] subchapter S status is a neutral consideration with respect to the valuation of its stock. Notwithstanding the tax advantages associated with subchapter S status, there are also noted disadvantages, including the limited ability to reinvest in the company and the limited access to credit markets. It is therefore unclear if a minority shareholder enjoys those benefits.

[18] Gross v. Commissioner, T.C. Memo 1999-254, aff'd, 272 F.3d 333 (6th Cir. 2001), cert. denied, 537 U.S. 827 (2002). The Sixth Circuit consists of Ohio, Michigan, Kentucky and Tennessee.

"tax affecting" the value of a pass-through entity if the appraiser makes a compelling presentation.[19]

1.2(e) **Economic Benefit of Current Life Insurance Coverage provided to a Shareholder by a Split Dollar Life Insurance Plan**

◊ Sole shareholder set up a split dollar life insurance plan with the premiums paid by an S corporation

◊ The S corp deducted the premiums. That did not fly on audit and the taxpayer conceded the point.

◊ The IRS thought the economic benefit of the life insurance each year was compensation income to the shareholder-employee.[20]

◊ The taxpayer argued that it was a tax-free distribution from the S corporation.

◊ The Tax Court was convinced by the IRS.[21]

◊ The Sixth Circuit found a Section 301 reg that the Court thought made it a distribution, so it reversed the Tax Court.[22]

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[19] Estate of Jones v. Comm'r, T.C. Memo 2019-101, CCH Dec. 61,518(M) (August 19, 2019).

[20] Treas. Reg. § 1.61-22(b)(2)(ii).

[21] Machacek v. Commissioner, 111 T.C.M. 1248 (2016), reversed.

[22] Machacek v. Commissioner, 2018-2 U.S.T.C. ¶50,447, (6th Cir. Oct. 12, 2018), relying on Treas. Reg. § 1.301-1(q)(1)(i).

◊ Observation: The only way the split dollar plan made sense is if the taxpayer played the audit lottery and deducted the premiums, hoping to avoid audit. The split dollar arrangement is a loan to the insured of the funds to pay the premiums. It never makes sense for a sole shareholder of an S corporation.

1.2(f) Equalizing Values with S Corp shares[23]

◊ Facts:

- Joe and Mary got divorced. Joe held S corp stock in his own grantor trust.[24] The S corp stock was pledged for a debt of Joe's. In their settlement agreement, Joe and Mary set up the JM Trust and Joe put the S corp stock in it. The JM Trust assumed the debt of Joe. The JM Trust had two equal shares – one for Joe and one for Mary.

- Mary gets distributions from the JM Trust during her lifetime, but the distributions end at her death.

- When the JM Trust received distributions from the S corp, it would pay down the debt that it assumed from Joe.

- To compensate Mary for having some of her distributions used to pay Joe's debt, Joe's share of the JM Trust gave a promissory note to Mary's share.

- Joe will get some distributions from the JM Trust that Mary will not get.

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[23] PLR 2018-34-007, May 18, 2018.

[24] Maybe it was his separate property, or maybe they did not live in a community property state.

◊ Issues:

- Does the distributions arrangement for the JM Trust create a second class of stock for the S corp?

- Does Mary acquire her interest in the JM Trust by purchase, preventing it from making an ESBT election?

◊ Second class of stock

- In a nutshell, the Trust document is not a "governing provision) of the S corp under the "one class of stock" regs, so it does not create a second class of stock.[25]

◊ Acquisition by purchase

- Because Section 1041 applied to the divorce settlement, basis was not determined under Section 1012, so it was not an acquisition by purchase for purposed of the ESBT rules.

◊ Other applications

- This could be useful when one or more descendants are nonresident aliens or there trusts are foreign trusts and the trust needs to distribute S corporation stock.

- If the trust allows it, the trustee can distribute a promissory note to the ineligible shareholders or trusts, and use S corporation distributions to the eli-

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[25] Treas. Reg. § 1.1361-1(*l*).

gible trusts to make payments to the ineligible trusts.

- Every trust that holds or might hold S corporation shares should allow this, if necessary to preserve the S corporation status.

1.2(g) **Agreement to Pay a Bonus at a Liquidity Event**

◊ A liquidity event bonus agreement

- If Evelyn remains employed with the target S corp continuously through the day of closing of a liquidity event, the S corp will pay to Evelyn a percentage of the sale price.

- The purpose is to keep key employees onboard during the anxiety-producing due diligence and sale process.

- It's up to the buyer to keep the key employees onboard after the closing date.

◊ Does the agreement create a second class of stock?[26]

- No, and no one thought it did. But now we have a PLR saying so.

1.2(h) **Does an agreement to buy shares back at termination of employment with different prices for different kinds of termination create a second class of stock**?

- No, and no one thought that it did.[27]

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[26] PLR 2019-26-008, March 29, 2019.

- It appears that the IRS refused to rule on whether the trusts to which employees proposed to transfer their shares were eligible to hold S corporation shares.

1.2(i) **Does a shareholder have two ways to get a partial closing of a tax year when the seller sells all of his or her S corporation shares**?

◊ S corporation redeemed all of Tom's shares effective as of March 31, 2009.

◊ Tom did not get the other shareholders to agree in the sale document to close the year as of the date of the sale.[28]

◊ The other shareholders probably deferred S corp's deductions into 2010 and accelerated receipts into 2009 to give Tom a little surprise on his K-1.

◊ Before the end of 2009, Tom asked the other shareholders to close the year as of the sale date, but they declined. Tom's K-1 allocated a portion of the whole year's income to him.

◊ Tom went to court and argued that under state contract law the "Further Assurances" clause in the sale contract required the shareholders to close the year on the sale date for purposes of allocating S corporation items.[29]

(footnote continued from previous page)

[27] PLR 2019-18-13, November 16, 2018.

[28] I.R.C. § 1377(a)(2).

[29] "Each of the Parties shall execute and deliver all such other instruments and take all such other actions as each other may reasonably request from time to time to effectuate the purposes of this Agreement."

◊ The other shareholders said "Come on, Judge, that's ridiculous. Please throw Tom out of your courtroom." But the judge declined.[30]

◊ Moral: In a stock purchase agreement for the purchase of S corporation shares, always have a Section 1377(a)(2) provision and say that the shareholders do or do not agree to make the Section 1377(a)(2) election.

- If the parties agree to make the election, state that the allocation made by the (named) CPA will be respected unless it is manifestly unreasonable.

◊ In a buy-sell agreement, I like to provide that if the board of directors (without the vote of the seller) and the seller agree to make the election, then all shareholders must go along with the election (which requires the consent of all who held shares during the year and, for community property shares, their spouses).[31] This minimizes the explaining for the advisors.

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[30] Manfre v, May, 2019 U.S. Dist. LEXIS 39678 (N.D. IL March 12, 2019) ("[Tom] contends that the purpose of the Agreement was to terminate [his]ownership interest in [the S corp] as of March 31, 2009. He alleges that the Section 1377 Election request was a reasonable means to effectuate that purpose because the Election would reflect [his] terminated interest in [the S corp] or its profits. [Tom's] complaint also states that the Defendants refused to honor the Election request, asserting that this conduct constituted a breach of the "Further Assurances" provision. Although the Agreement did not expressly require the Defendants to sign a Section 1377 Election request, the "Further Assurances" provision could plausibly be construed to require the Defendants to accommodate the request because it would appear reasonable for a business owner terminating his interest in a company to stop paying taxes on income earned by the company after the termination date. Given that [Tom's] request could be construed as reasonable, the Defendants' alleged conduct would be a violation of the "Further Assurances" provision and constitute a breach of the Agreement. Accordingly, [Tom] has plead all the necessary elements of a breach of contract dispute, so the Defendants' motion to [throw Tom out of the courtroom] is denied.")

[31] Treas. Reg. § 1.1377-1(b)(5)(ii).

◊ Note that Section 1377(a)(2) does not require a short-year tax return or a physical inventory at the closing date. It is just an alternate way of allocating tax items to the shareholders during the year.

1.2(j) **How the GILTI rules apply to S corps**

◊ The IRS intends to issue regulations that will permit a domestic partnership or S corporation to apply the rules in proposed §1.951A-5 for taxable years ending before June 22, 2019.[32]

◊ The notice also addresses how penalties apply for a domestic partnership or S corporation that acts consistently with proposed §1.951A-5 on or before June 21, 2019, but files a tax return consistent with the final regulations under §1.951A-1(e).

1.2(k) **How much compensation is enough for an S corp**?

◊ Let's ask Joe Biden

- Comp: $300,000
- Profit - $2.7M[33]

◊ Is there a 1/10th rule? Or a $300,000 rule? Well, Joe must have some pretty well-connected advisors.

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[32] Notice 2019-46, 2019-37 I.R.B. (Sept. 9, 2019).

[33] R. Willens, *INSIGHT: Vice President Biden Used Common Tax Planning Technique*, Daily Tax Report (BNA) (July 19, 1019).

2. USING A HOLDING COMPANY STRUCTURE FOR MULTIPLE LOCATIONS

2.1 Sample factual situation

- Assume an existing Chatsworth store and an Encino store, with a Burbank store on the way. The Chatsworth store and the Encino store each has its own S corporation, with the same shareholders of each. The intellectual property is owned by the Chatsworth corporation. The backroom functions are also handled by the Chatsworth corporation. There are no licenses in place. The owners ask if setting up an entity for the Burbank store is the best structure.

- The intellectual property owned by the Chatsworth entity is available to the creditors of the Chatsworth entity.

2.2 Steps

- Exchange the shares of the Chatsworth and Encino corporations for shares of a new holding company and make an S corporation election for the holding company. This will make the Chatsworth and Encino corporations wholly-owned subsidiaries of the holding company, which will be owned by the former shareholders of the Chatsworth and Encino corporations.

- The holding company makes QSub elections for the Chatsworth and Encino corporations. The exchange and the QSub elections constitute a non-divisive Type D reorganization.

  - It's not a Type F reorganization because two corporations become one corporation. If there was no Encino corporation, the steps of making the Chatsworth corporation owned by the holding company and the QSub election for the Chatsworth store would be a Type F reorganization.[34] But if the S parent already existed and acquired the

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[34] Rev. Rul. 2008-18, 2008-1 C.B. 674.

Chatsworth corporation and made a QSub election for it, the transaction could not be a Type F because it involves two corporations (not one), so it could be a non-divisive Type D.[35]

- If the transaction is both a non-divisive Type "D" reorganization and a Section 351 transaction, Section 357(c) (gain to the extent that liabilities exceed basis) will not apply.[36] The same rule would apply if the transaction could be a Section 351 or a Type F reorganization – no Section 357(c) gain.[37]

- This is a good thing, because gain recognition under Section 357(c) is possible in a Section 351 transaction but not in a non-divisive Type D reorganization or a Type F reorganization.[38]

- A new QSub is created to hold the intellectual property and to license it to the operating subsidiaries. I am told by IP attorneys that IP subsidiary must also provide management services, so that in the event of an infringement of the IP, the IP subsidiary can stop the infringer from using its IP. If the IP subsidiary did not also provide management services, it would only be able to get royalties from the infringer and could not stop the unauthorized use.

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[35] See Treas. Reg. § 1.368-2(m)(1)(v), (m)(4) *Example (14)*.

[36] Rev. Rul. 2001-8, 2007-1 C.B. 469.

[37] Rev. Rul. 79-289, 79-2 C.B. 145 (parent and subsidiary merge into NewCo, so it is curious that this could be a Type F reorg). See also Rev. Rul. 57-276, 57-1 C.B. 405 (Type "F" reorg trumps Types A, C or D).

[38] Example 3 in Section 1361-4(a)(2)(ii) of the Treasury regulations, indicates that Section 357(c) is a concern in a non-divisive Type D, but 2004 legislation made Section 357(c) inapplicable to a "non-divisive Type D" reorganization. H.R. 4520, § 898(b) (2004), changing I.R.C. § 357(c)(1)(B).

- The holding company does not have any activity. This way, it is nearly judgment-proof, even though it holds valuable shares.

[End of outline.]