



Bureau adjusted Petitioners' returns to include the property distributions and sent them a Notice of Deficiency Determination.

Petitioners protested the Notice of Deficiency Determination and provided revised schedules of how Petitioners' basis in [Redacted] should be determined. Petitioners stated the property distributions were a misclassification that should have been contributions of capital or loans to the corporation. The Bureau reviewed the schedules but found no support for Petitioners' claim. Consequently, the Bureau referred the matter for administrative review.

The Tax Commission reviewed the matter and sent Petitioners a letter that discussed their options for redetermining a protested Notice of Deficiency Determination. Petitioners requested a hearing, but on the date of the hearing, Petitioners had nothing to present, so a short telephone conference was held in place of the hearing.

In 2005, Petitioners operated a [Redacted] business as a sole proprietorship. In 2006, Petitioners decided to incorporate their business and chose the form of an S-Corporation, [Redacted]. All Petitioners' business assets and liabilities were transferred to [Redacted]. Because Petitioners depreciated the assets but did not retain the debt associated with the assets, Petitioners realized a gain on the transfer of the debt to [Redacted]. The amount of the gain realized by Petitioners was likely greater than the capital they contributed to [Redacted]. Therefore, Petitioners' beginning basis in [Redacted], when [Redacted] was organized, was zero, and Petitioners should have reported a gain on the transfer.

In 2006, [Redacted] was profitable and income flowed through to Petitioners increasing their basis in [Redacted]. In 2007, [Redacted] generated a loss, and in 2008, [Redacted] produced income.

Petitioners and [Redacted] were audited by [Redacted] for the reimbursements they received in 2005 and 2006. [Redacted] determined Petitioners and [Redacted] were over reimbursed by \$500,000 to \$600,000. Petitioners and [Redacted] protested [Redacted] determination figuring they could settle for somewhere around \$276,000. Since both Petitioners' sole proprietorship and [Redacted] were on the accrual basis, neither Petitioners nor [Redacted] included the \$276,000 in income. The [Redacted] audit was settled for an amount close to the estimate, and Petitioners borrowed the money to repay [Redacted].

As previously mentioned, Petitioners received property distributions [Redacted] in 2006, 2007, and 2008. Generally, property distributions from an S-Corp are treated as a recovery of capital contributed by the shareholders and reduce the shareholders' basis in the S-Corp. In this case, Petitioners/shareholders had very little or no basis in [Redacted]; therefore the Bureau determined the property distributions in excess of Petitioners' basis should be taxed as capital gain income. The Bureau computed the amount of the excess property distributions from the information provided on [Redacted] corporate income tax returns.

Petitioners' representative stated the property distributions were misclassified and should be treated as loans or additional paid-in capital. He stated Petitioners had to pay the distributions back and took out a loan to do so. The representative stated it was a timing issue and everything will wash in time.

## **LAW AND ANALYSIS**

Internal Revenue Code section 1366(a) states:

(a) Determination of shareholder's tax liability.

(1) In general. In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's

- (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
- (B) nonseparately computed income or loss

Internal Revenue Code section 1366(d) states:

(d) Special rules for losses and deductions.

(1) Cannot exceed shareholder's basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

[Redacted] first year of operation was 2006. According to [Redacted] balance sheet, Petitioners contributed \$2,000 in capital and transferred \$451,549 in assets subject to \$322,702 of liabilities and \$133,671 of depreciation. Petitioners' beginning basis in [Redacted] at most was \$2,000 but was likely zero. In 2006, [Redacted] reported ordinary income of \$37,260 which increased Petitioners' basis. Petitioners also received property distributions of \$13,862 which decreased Petitioners' basis. Petitioners had no outstanding loans to or [Redacted] at the end of 2006. In the simplest terms (without taking into account nondeductible expenses and section 179 depreciation) Petitioners' basis in [Redacted] was \$25,398.

In 2007, [Redacted] reported a \$14,480 loss from operations. Petitioners also received property distributions of \$122,453. Both the loss and the distributions decreased the Petitioners' basis. Petitioners had no outstanding loans to or [Redacted] at the end of 2007 and Petitioners made no contributions [Redacted] in 2007. Again, in the simplest terms, Petitioners' basis was reduced to zero, and the Petitioners received property distributions in excess of their basis.

In 2008, [Redacted] reported income in the amount of \$19,300. [Redacted] also distributed property to Petitioners in 2008 in the amount of \$63,490. In 2008, Petitioners had no outstanding loans to or [Redacted] and they contributed no additional capital [Redacted]. Petitioners' basis [Redacted] was increased by the income and decreased by the distribution. At the end of 2008, Petitioners' basis [Redacted] was zero, and they received a property distribution in excess of their basis.

Petitioners argued the property distributions made in all three years were misclassified and should have been classified as loans to or contributions [Redacted]. In either case, Petitioners would have had an economic outlay which was never established by Petitioners, and [Redacted] reported exactly the opposite. Petitioners stated they personally borrowed money to pay [Redacted]; therefore, the distributions were essentially paid back to [Redacted]. Yet, in [Redacted] records, there is no indication of additional contributions from Petitioners or loans from Petitioners.

Petitioners do not disagree they received distributions from [Redacted]. Internal Revenue Code section 1368 provides for the treatment of distributions from S-Corporations, it states in part:

(a) General rule.

A distribution of property made by an S corporation with respect to its stock to which (but for this subsection ) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c) , whichever applies.

(b) S corporation having no earnings and profits.

In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits—

(1) Amount applied against basis.

The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

(2) Amount in excess of basis.

If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

(c) S corporation having earnings and profits.

In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits—

(1) Accumulated adjustments account.

That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).

(2) Dividend.

That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

(3) Treatment of remainder.

Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

In this case, [Redacted] had no earnings and profits for taxable years 2006 and 2007, and a small amount of earnings and profits in taxable year 2008. [Redacted] accumulated adjustments account for each of the three years had a negative balance which was fueled by the distributions made to Petitioners. Petitioners had little to no basis in [Redacted] when it was formed; therefore, any distributions [Redacted] made to Petitioners are to be treated as a gain from the sale or exchange of property. In other words, Petitioners realized income from the distributions.

## CONCLUSION

When Petitioners chose to incorporate, they chose all the benefits and pitfalls of the structure chosen. Most of the downsides of S-Corporations are tied to the shareholder's basis in the S-Corporation. Recognition of gain from property distributions is one such item tied to a shareholder's basis. From the information available, it appears Petitioners' basis [Redacted] was zero or nearly zero. As a result, any distribution [Redacted] is a gain that Petitioners are required to report on their individual income tax return.

THEREFORE, the Notice of Deficiency Determination dated March 19, 2010, and directed to [Redacted] is AFFIRMED.

IT IS ORDERED that Petitioners pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$9,472	\$1,959	\$11,431
2008	4,293	612	<u>4,905</u>
		TOTAL DUE	<u>\$16,336</u>

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the Petitioners' right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2012.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2012, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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