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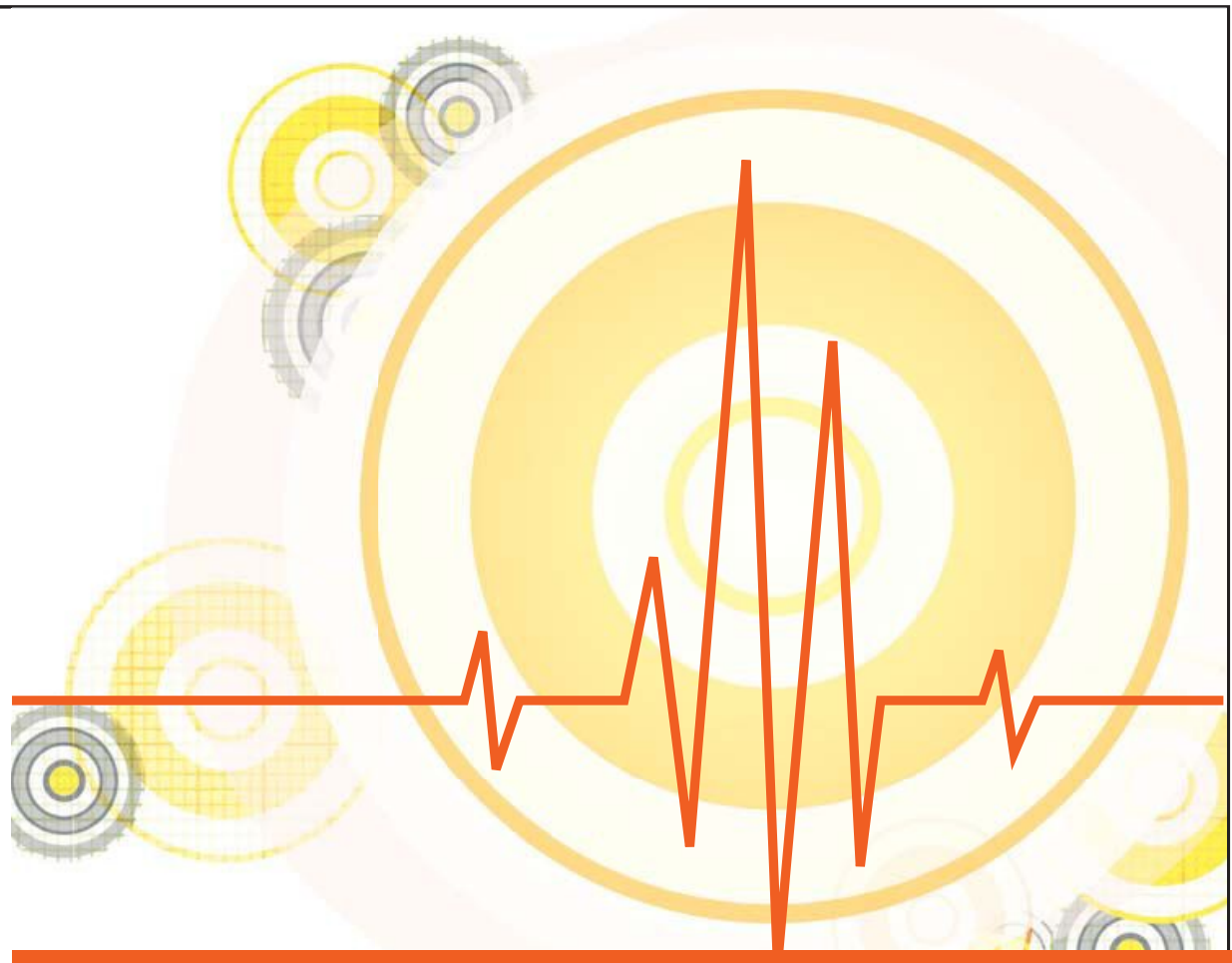

Inside This Issue

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Me, Myself, and I – Don't Crash the Related Party

Most tax professionals are aware that some transactions may have limited or no tax benefits if conducted between "related parties." Defined explicitly in the Internal Revenue Code (IRC), related parties include members of the same family, a taxpayer and a corporation of which more than 50 percent of the corporate stock is owned by the taxpayer, a grantor and a trust's fiduciary, and corporations within a controlled group.

Some examples where tax benefits are limited include:

- A father who sells stock at a loss to his son cannot claim a capital loss. Similarly, one corporation cannot sell assets to another corporation at a loss if they are both in the same controlled group (although the loss is deferred until the buyer corporation sells the assets outside the controlled group).
- An S corporation shareholder who borrows funds from another shareholder of the S corporation is not considered at risk with regard to the debt. Therefore, the debt does not increase the debtor shareholder's amount at risk in the S corporation, and he cannot deduct his pro-rata share of losses in the S corporation that exceeds his amount at risk.
- Ordinary income (not capital gain income) is recognized on any gain when a partner who owns more than 50 percent of a partnership sells property to the partnership that is not a capital asset in the hands of a partnership.

Note that the two individuals or parties also can be one and the same taxpayer. A common example is a self-employed taxpayer who makes contributions to his or her own retirement account—the "employer" contributes funds on behalf of the "employee." The same self-employed taxpayer also pays both the employer part of self-employment tax as well as the employee's portion.

Other examples include a taxpayer who owns 100 percent of an S corporation to which s/he rents office space or extends a loan, or the taxpayer who manages real estate held by his/her IRA. In the latter example, the taxpayer serves as the trustee, the account owner, and the real estate manager "employed" by the IRA.

There are many more examples of such multiple relationships. Following are questions asking about the tax consequences of loans between shareholders and their S corporations, meal and entertainment expenses incurred by a business owner, the applicability of the self-rental rule between S corporations owned by a single taxpayer, and an IRA owner who may be undertaking prohibited transactions.

S CORPORATION EMPLOYEE / SOLE SHAREHOLDER AND HOME OFFICE

Q: My client is the sole shareholder and employee of an S corporation. He charges the corporation rent for an office in his home that he uses exclusively for work related to the company. If the corporation deducts the rental payment, can he deduct expenses for the home office? If so, how would these be reported?

A: First, the corporation should be paying your client a reasonable salary for services performed for the corporation. If not, any payments made by the corporation to your client could be recharacterized as wages, and the corporation could be responsible for past-due payroll taxes and associated penalties.

If your client is compensated for services performed, the corporation may also pay rent to your client for use of the home office; these should be unrelated transactions. Again, the rental payment must be a fair rental value and not be perceived as disguised compensation or a constructive distribution. It is important to note that the requirements for a home office (used exclusively and regularly for business purposes) apply when the taxpayer deducts home office expenses—not when the corporation pays rent for office space.

When an S corporation leases home office space from an employee-shareholder, the shareholder must report all the rental income, but may only deduct expenses that would be allowable without regard to business use of the home, such as mortgage interest, real estate taxes, and personal casualty losses.

Another option is for the corporation to simply reimburse your client for office expenses. If the reimbursement was made under an accountable plan, the corporation could deduct the expense, and your client does not need to report the reimbursement as income (nor could he deduct any office expense).

MEALS AND ENTERTAINMENT EXPENSES

Q: My client owns 100 percent of an S corporation and a limited liability company (LLC) that is taxed as an S corporation. The client, who is an employee, travels on business quite often to market his business.

Is the deduction for meals and entertainment for marketing his business subject to the 50-percent limit? If the client takes three customers to dinner, does the 50-percent limit apply only to the meals paid for the customers, and can he deduct 100 percent of his own meal? Finally, are meals 100 percent deductible by the S corporation and LLC if they bring meals in to employees working late at the office?

A: A deduction for meals and entertainment is limited to 50 percent of the cost. If the meals and entertainment were made available to the general public, the cost would be fully deductible. For example, meals provided in a community fair sponsored by the S corporation would be fully deductible. However, if your client takes only a few people to dinner to market the client's business, the 50-percent limit applies.

Meals are fully deductible if paid by the corporation and provided to employees at work for the employer's convenience (and the value of the meal is excludable by the employee).

SELF-DIRECTED IRA

Q: I have a client who is looking into purchasing real estate through a self-directed IRA. His IRA balance is at least three times the amount of the mortgage, but the bank will not lend directly to his IRA. Can he personally guaranty the mortgage to get the financing to purchase the real estate?

A: Your client is not allowed to guaranty a loan on behalf of his self-directed IRA because that is considered a prohibited transaction. And while there is no prohibition against an IRA investing in real estate, there are several additional caveats to consider with self-directed IRAs. First, the owner cannot live in or personally use the real estate.

Also, the owner must be careful not to furnish goods and services to the IRA in managing the real estate. For example, if the IRA owner cleans or maintains the property, he or she may be engaging in a prohibited transaction with the IRA. The expenses of maintaining the property and making mortgage payments, tax payments, etc., must all be borne by the IRA. If the individual were to pay for expenses of property owned by his IRA, the expenditures would be treated as IRA contributions. If these expenditures exceeded the contribution limit, your client would be subject to the excess contribution penalty (6 percent of the excess contributions). Therefore, the IRA should have sufficient liquid assets available to pay for all expenses of the property.

On that note, an IRA that contains real estate is no different than any other IRA when the owner must take required minimum distributions. Due to the increased need for liquid assets in the account to make distributions, the IRA may need to sell the property or distribute the asset in kind in order to avoid penalty for failure to distribute the required amount.

Another caveat is that the custodian or trustee of the IRA must value the IRA account annually. When real estate is held in the account, this generally means that the IRA will have to pay for a real estate appraisal each year to allow the custodian to file Form 5498 (IRA Contribution Information).

Finally, real estate that is debt-financed in an IRA can create unrelated business taxable income (UBTI) for the IRA. If the investment produces income, the income will be subject to tax to the extent it was purchased by borrowing. In this situation, the IRA would need to file Form 990-T (Exempt Organizaion Business Income Tax Return) to report the taxable income of the IRA, and the IRA would need to pay the tax on any UBTI.

SHAREHOLDER LOANS

Q: My client loaned money to his business (an S corporation). What are the restrictions, if any, for a 100 percent S corporation shareholder loaning money to his corporation for a stated interest rate? Are there limitations when he is the only shareholder? Does the IRS restrict this activity in any way? Does the IRS classify this as paid-in-capital only?

A: The issue of whether funds transferred from a shareholder to an S corporation is a loan or a contribution of capital is an area that can be subject to close IRS scrutiny. The IRS has the authority to reclassify a transaction as a capital contribution under certain circumstances. There are several key elements used to determine whether a shareholder's transfer to a corporation is a loan or a capital contribution. For example, some of these factors are whether:

- There is a written, legally enforceable agreement between the corporation and the shareholder;
- The loan is set at a market rate of interest, and interest payments are made on a regular basis (or in accordance with the terms of the loan);
- The corporation could have obtained a loan from a third party (instead of the shareholder);
- The debt is collateralized; and/or
- The corporation is sufficiently capitalized without the shareholder's loan.

The effect of whether a transfer of funds to a wholly owned corporation is classified as debt or equity affects the shareholder's debt or stock basis. This in turn affects the shareholder's ability to claim losses and any gains or losses from the sale or disposition of the company.

REFERENCES

IRC Secs. 267, 274, 465(b)(3)(A), 707, 1366(d)(1), 1563, 4975(c)(1)(B) and (C)
Reg. Sec. 1.1366-2(a)(3)(ii)
IRS Pub. 544, Sale and Disposition of Other Assets (Sales and Exchanges between Related Persons)
CCA 200121070