

# CaseStudy

## ALLOCATING PASSTHROUGH ITEMS TO S CORPORATION SHAREHOLDERS

PASSTHROUGH ITEMS FROM AN S CORPORATION are allocated on a per-share, per-day basis (Sec. 1377(a)(1)). Unlike partnerships, there is no provision for special allocations. Generally, this means that passthrough items for the entire year are allocated equally to each day of the tax year and are in turn allocated equally among the shares of stock outstanding on each day of the tax year.

**Example 1:** *GHI Corp.* is an S corporation that reports on a calendar year. The corporation's shares are owned 50% by *G* and 50% by *H*. For the four months ending April 30, 2008, the company shows a \$60,000 loss, but during the next three months of the year it has \$30,000 net income. During the final five months, *GHI* has \$20,000 net income, resulting in a \$10,000 net loss for the year. The loss is the only passthrough item for the year. How is the income or loss allocated to the shareholders?

Under the per-share, per-day method, non–separately stated income or loss

and separately stated items for the entire tax year are allocated among the shareholders. Here, the net loss for the year (\$10,000) is allocated 50% (\$5,000) to *G* and 50% (\$5,000) to *H*. The \$10,000 loss is reported on Schedule K of Form 1120S, U.S. Income Tax Return for an S Corporation, and each shareholder's \$5,000 portion is passed through on a separate Schedule K-1.

### Allocations When Ownership Changes

The allocation is more complex when ownership changes during the year.

**Example 2:** On May 1, 2008, *I* begins working for *GHI* and enters negotiations to buy *GHI* stock. On July 31, *I* acquires half of *H*'s shares. All the shareholders actively participate in the business. *I* asks his tax practitioner if he can report part of the loss on his individual return, even though the loss occurred before he acquired his shares. Can *I* benefit from the loss incurred before he purchased his shares?

When shares change hands during the year, application of the per-share, per-day method is very cumbersome. The instructions to Form 1120S, however, set out a simplified method. The allocation under this method is made by multiplying the percentage of stock owned by the percentage of the year it is owned and applying the resulting percentage to the corporation's income for the year. Using that

method, the passthrough to *G*, *H*, and *I* is as shown in the exhibit on p. 846. Each passthrough item is allocated to the shareholders based on these percentages. Here, the only item is \$10,000 of ordinary loss, and it is passed through as follows:

<i>G</i>	$10,000 \times 50.0\%$	\$ (5,000)
<i>H</i>	$10,000 \times 39.5\%$	(3,950)
<i>I</i>	$10,000 \times 10.5\%$	<u>(1,050)</u>
Total		<u>\$ (10,000)</u>

The shareholders report the passthrough losses on their 2008 returns (i.e., in the tax year that includes the last day of the S corporation's tax year) (Sec. 1366(a)(1); Regs. Sec. 1.1366-1(a)(1)).

Because of the allocation method used, *I* benefits from the loss incurred before he purchased his shares. The allocation of passthrough from the S corporation is calculated on a per-share, per-day basis for the entire year because the corporation did not make the election to use specific accounting. *I* is therefore passed through his proportionate share of loss for the tax year. This result produces a substantially lower passthrough to *I* than would have been allocated to him under the specific accounting method.

If *I* had purchased his shares earlier in the year, his proportionate share of the loss would have been larger. Thus, *I* could have increased his share of the loss had he been able to negotiate an effective date of, for

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## Exhibit: Passthrough to *G*, *H*, and *I*

	(a) (% of stock)	(b) (% of year)	(c) (a) × (b)	(d) (Total %)
<i>G</i>	50	100	50%	50
<i>H</i> (prior to sale)	50	58.2*	29%	
<i>H</i> (after sale)	25	41.8†	10.5%	39.5
<i>I</i>	25	41.8†	10.5%	<u>10.5</u>
Total				<u>100</u>

\* 213 days ÷ 366 days (Percentage is based on 366 days in a leap year.)

† 153 days ÷ 366 days

example, April 30 to purchase the shares. Although the additional loss allocated to *I* would have been small, the practitioner should be alert to the significant effects timing can have in planning the purchase or sale of S corporation stock.

### Specific Accounting Elections

An S corporation can make an election to treat the tax year as if it consisted of two tax years (i.e., the election to apply specific accounting rules in connection with the termination of a shareholder's entire interest) (Sec. 1377(a)(2)). The specific accounting election allows the S corporation to allocate to the departing shareholder only passthrough items attributable to the specific period of time the shareholder owned stock. It requires the consent of shareholders affected by the stock disposition, which for these purposes is the terminated shareholder and all shareholders to whom the terminated shareholder transferred stock during the tax year. The election is made with the corporate tax return, allowing the shareholders to use hindsight to select the most beneficial method of allocating passthrough items. However, if the election is beneficial to the departing shareholder, it probably will be detrimental to the new shareholder. Therefore, the shareholders should consider the election when preparing the terms of the stock sale agreement.

Furthermore, the Sec. 1368 regulations (relating to distributions) authorize the S corporation to elect to use specific accounting and treat the tax year as if it consists of separate years when there is a

qualifying disposition (Regs. Sec. 1.1368-1(g)(2)). A qualifying disposition occurs when:

1. A shareholder disposes of 20% or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's tax year;
2. 20% or more of its outstanding stock is redeemed from a shareholder within any 30-day period during the tax year, if the redemption is treated as an exchange under Sec. 302(a) or Sec. 303(a); or
3. Stock equal to or greater than 25% of the previously outstanding stock is issued to one or more new shareholders within any 30-day period during the corporation's tax year.

All shareholders who held stock during the tax year must consent to the election. This differs from the election to use specific accounting when a shareholder disposes of his or her entire interest in the corporation, which requires only that affected shareholders must consent. If the event resulting in a qualifying disposition also results in a termination of a shareholder's interest, only the election under Sec. 1377(a)(2), and not the election under Regs. Sec. 1.1368-1(g)(2), can be made.

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### EditorNotes

Albert B. Ellentuck is of counsel with King & Nordlinger, L.L.P., in Arlington, VA.