17.0 MISCELLANEOUS

17.1 FRINGE BENEFITS - BACKGROUND

Generally, we do not pursue fringe benefits as an independent issue. However, we will pursue fringe benefit issues in conjunction with other issues if tax potential warrants require examination. This chapter identifies special rules applicable to fringe benefits provided by S corporations.

A fringe benefit is a form of pay for the performance of services. For example, an S corporation provides a fringe benefit to an employee when the S corporation allows the employee to use a business vehicle to commute to and from work.

A person who performs services for an S corporation doesn't need to be an employee of the S corporation. A person may perform services for the S corporation as an independent contractor, shareholder, or director. Also, for fringe benefit purposes, a person who agrees not to perform services (such as under a covenant not to compete) is treated as performing services. (Federal Regulation Section 1.61-21(a)(3))

An S corporation is a provider of a fringe benefit if it is provided for services performed for the S corporation. An S corporation is considered the provider of a fringe benefit even if a third party, such as a client or customer, provides the benefit to the S corporation's employee for services the employee performs for the S corporation. For example, if, in exchange for goods or services conducted by the employees, the S corporation's customer provides day care services as a fringe benefit to the S corporation's employees, then the S corporation is the provider of this fringe benefit even though the customer is actually providing the day care.

The person who performs services for the S corporation is considered the recipient of a fringe benefit provided for those services. That person may be considered the recipient even if the benefit is provided to someone who didn't perform the services for the S corporation. For example, the S corporation's employee may be the recipient of a fringe benefit the S corporation provided to a member of the employee's family. (Federal Regulation Section 1.61-21(a)(4))

Any fringe benefit an S corporation provides is taxable and must be included in the recipient's pay unless the law specifically excludes it. (Federal Regulation Section 1.61-21(a)) Employees of an S corporation must report their taxable fringe benefits on Form W-2.

The following are some examples of fringe benefits that may or may not be excluded from the recipient's taxable income (IRS Publication 15-B):

- Accident and health benefits
- Achievement awards
- Adoption assistance
- Athletic facilities
- De minimis (minimal) benefits
- Dependent care assistance
- Educational assistance
- Employee discounts
- Employee stock options
- Employer-provided cell phones
- Group-term life insurance coverage
- Health savings accounts (HSAs)
- Lodging on the business premises
- Meals
- No-additional-cost services
- Retirement planning services
- Transportation (commuting) benefits
- Tuition reduction
- Working condition benefits

17.1.1 Fringe Benefits - 2-Percent Shareholder

Generally, the rules applicable to C corporations apply to fringe benefits provided by S corporations. However, where the employee receiving the fringe benefit is also a "2-percent shareholder" in the S corporation special "partnership" rules apply. (Internal Revenue Code (IRC) Section 1372; California Revenue & Taxation Code (R&TC) Section 23807)

IRC Section 1372 provides that, for purposes of applying the income tax provisions of the Code relating to employee fringe benefits, an S corporation shall be treated as a partnership, and any person who is a "2-percent shareholder" of the S corporation shall be treated like a partner of a partnership. Section 1372(b) defines a "2-percent shareholder" as any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of the corporation or stock possessing more than 2 percent of the total combined voting power of all stock in the corporation.

Employee fringe benefits paid or furnished by an S corporation to or for the benefit of its 2-percent shareholder in consideration for services rendered are treated for income tax purposes like partnership guaranteed payments under IRC Section 707(c). An S corporation is entitled to deduct the cost of such employee fringe benefits under IRC Section 162(a) if the requirements of that section are satisfied (taking into account the rules of IRC Section

263). Like a partner, a 2-percent shareholder is required to include the value of such fringe benefits in gross income under IRC Section 61(a).

Although, IRC Section 1372 does not identify the specific fringe benefits to which it applies, the legislative history (Senate Report 97-640 (PL 97-354) p. 22) indicates that IRC Section 1372 was intended to govern the following types of statutory fringe benefits:

1. Exclusion under IRC Section 79 of the cost of the first $50,000 of group-term life insurance on the life of an employee.

2. Exclusion under IRC Sections 105(b) and 105(c) for amounts paid by an employer for or as reimbursement of an employee's medical care expenses or compensation for certain payments unrelated to absence from work.

3. Exclusion under IRC Section 106 for employer costs toward an employee's accident and health insurance coverage.

4. Exclusion under IRC Section 119 for meals or lodging furnished for the convenience of the employer.

A Cafeteria Plan does not include an S corporation 2-percent shareholder. (Proposed Federal Regulation Section 1.125-1(g)(2))

The following list includes fringe benefits that are available to partners in a partnership, which should not be affected by IRC Section 1372 (See list on Internal Revenue Code - Subtitle A, Chapter 1, Subchapter B, Part III Items Specifically Excluded from Gross Income) :

- Certain employee achievement awards (IRC Section 74(c))
- Educational assistance programs (IRC Section127)
- Dependent care assistance programs (IRC Section 129)
- No-additional-cost services (IRC Section 132(b))
- Qualified employee discounts (IRC Section 132(c))
- Working condition fringe benefits (IRC Section 132(d))
- De minimis fringe benefits (IRC Section 132(e))
- On-premises athletic facilities (IRC Section 132(j)(4))

Also, IRC Section 132 – Certain Fringe Benefits includes other benefits that may be available to the 2-percent shareholders.

17.1.2 Method of Reporting 2-Percent Shareholder Fringe Benefits

Fringe benefits paid on behalf of a **2-percent shareholder** should be reported on the S corporation's income tax return as either compensation of officers or salaries and wages, whichever applies. The S corporation is also required to report the fringe benefits as wages in box 1 of Form W-2. (See Instructions to Federal Form 1120S, (2015), p. 16.) The 2-

percent shareholder must include the fringe benefits in gross income as wages. (Revenue Ruling 91-26, 1991-1 CB 184, IRC Section 1372)

Example A

ABC, Inc. is an S corporation, which has three employees, all of whom are stockholders: Alicia, with 51% of the stock, Susie, with 48%, and Jessee, with 1%. Alicia and Susie are 2-percent shareholders, and Jessee is not because she does not meet the rules of a 2-percent shareholder. (IRC Section 1372(b)) ABC, Inc. has taxable income, before considering health insurance premiums of $100,000. It pays the following health insurance premiums: Alicia $6,000; Susie $7,000; and Jessee $7,000.

ABC, Inc. deducts the health insurance premiums paid for Alicia and Susie as compensation to officers, and it deducts the health insurance premiums paid for Jessee as an employee benefit. Both deductions qualify as an ordinary business expense. As a result, ABC's taxable income is reduced by the health insurance premiums to $80,000. Alicia and Susie must include the full amount of the premiums in income. Therefore, Alicia's share of income from ABC is $46,800 ($80,000 X 51% + $6,000), and Susie's share of income from ABC is $45,400 ($80,000 X 48% + $7,000). Jessee's share of income from ABC is $800 ($80,000 X 1%). However, Jessee is not required to include the health insurance premium paid by ABC in income because she is not a 2-percent shareholder.

A 2-percent shareholder may be allowed to deduct a health insurance premium on Federal Form 1040, line 29. (See instructions to federal Form 1040, (2015), pages 32 and 33.)

17.2 SPECIAL RULES APPLICABLE TO S CORPORATION INTEREST

If an S corporation pays interest to persons who are related to the S corporation, the S corporation is not entitled to the deduction for interest contained in IRC Section 163 until the year that the related person's accounting method would require the inclusion of the interest in the related person's income. (IRC Section 267(a)(2)) IRC Section 267 governs the deductibility with respect to transactions between related persons. For purposes of this timing rule, related persons include:

- A shareholder in anS corporation.
- Members of a shareholder's family.
- An S corporation and a C corporation where the same person owns more than 50 percent in value of the outstanding stock of each corporation.
- Two related S corporations where the same person owns more than 50 percent in value of the outstanding stock of each S corporation.
- An S corporation and a partnership if the same person owns more than 50 percent in value of the outstanding stock of the S corporation and more than 50 percent of the capital interest, or profits interest in the partnership. (IRC Sections 267(b) and (e))

With respect to S corporations, IRC Section 1361(b)(1)(D) states that S corporations are permitted to have only one class of stock. However, differences in voting power among shares are allowed. (1361(c)(4) An S corporation can have only common stock (e.g., voting

common stock and nonvoting common stock) since the term "preferred stock" means there has to be another class of stock that the preferred stock has some preference over.

For purposes of determining whether a payee of interest is a related person described above, special attribution rules apply, which are contained in IRC Section 267(c).

Verify that the related persons/creditors are reporting interest income in the same year that the S corporation is deducting interest expense in regard to S corporation indebtedness to the related persons/shareholders. If not, the interest expense is not an allowable deduction to the S corporation in that year.

17.3 BELOW – MARKET INTEREST RATE LOANS; IRC SECTION 7872

17.3.1 General – Below-Market Interest Rates Loans

California R&TC Sections 18180 and 24993, which incorporate IRC Section 7872, provide the rules for treating a below-market loan that meets the provisions of a demand loan or a term loan and the forgone interest related to any below-market loan. The term "below-market loan" means any loan if:

(1) In the case of a demand loan, interest is payable at a rate **less** than the Applicable Federal Rate (AFR); or

(2) In the case of a term loan, the amount loaned **exceeds** the present value of all payments due under the loan, determined as of the day the loan is made, using a discount rate equal to the Applicable Federal Rate in effect on the day the loan is made.

Forgone interest means, with respect to any period during which the loan is outstanding, the **excess** of the amount of interest which would have been payable on the loan for the period if interest accrued on the loan at the Applicable Federal Rate and were payable annually on the day referred to in IRC Section 7872 (a)(2), **over** any interest payable on the loan properly allocable to such period. (IRC Section 7872(e)(2)

For a demand loan, the forgone interest attributable to periods during any calendar year is treated as transferred from the lender to the borrower, and retransferred by the borrower to the lender on December 31 of that calendar year and shall be treated for tax purposes in a manner consistent with the taxpayer's method of accounting. (Proposed Regulation Section 1.7872-6(b))

For a term loan, the amount of the additional payment by the lender to the borrower is treated as transferred at the time the loan is made. The amount transferred is equal to the excess of the amount loaned over the present value of all payments determined by using the AFR for that date. This excess is treated as original issue discount (OID) under Code Sec. 1272. The annual portion of this OID is reported as interest income or a deduction depending upon the type of loan and the reporting party. (Proposed Regulation Section 1.7872-7(a).

In general, the Applicable Federal Rate is an annual stated rate of interest based on a semiannual compounding. The Commissioner may prescribe equivalent rates based on a different compounding period. IRC Section 7872 does not apply to any loan which has sufficient stated interest. A loan has sufficient stated interest if it provides for interest on the outstanding loan balance at a rate **no** lower than the Applicable Federal Rate based on a compounding period appropriate for that loan. (Proposed Regulation 1.7872-3(b))

A "demand loan" is any loan which is payable in full at any time on the demand of the lender (or within a reasonable time after the lender's demand) or a loan with an indefinite maturity. A "term loan" is a loan if the loan agreement specifies an ascertainable period of time during which the loan is to be outstanding. For purposes of this rule, a period of time is treated as being ascertainable if the period may be determined actuarially. (Proposed Regulation Section 1.7872-10(a))

IRC Section 7872 applies **only** to certain categories of below-market loans. (Proposed Regulation Section 1.7872-4) The following are the categories:

1. Gift loans

2. Compensation-related loans

3. Corporation-shareholder loans

4. Tax avoidance loans

5. Certain below-market loans with significant effect on tax liability ("significant-effect" loans)

17.3.2 Below-Market Interest Rate Rules for S Corporation - Shareholder Loans

Under Proposed Regulation Section 1.7872-1(a) loans between an S corporation and a shareholder that lack either an interest rate, or a rate that reflects market conditions are considered "below-market loans" and must be recharacterized to reflect the reality of the underlying transaction. Loans subject to recharacterization are deemed to be **two** transactions:

1. A loan to the borrower in exchange for a note that requires the payment of interest at the Applicable Federal Rate, and

2. An additional payment to the borrower.

Depending upon the underlying transaction, the additional payment for an S corporation-Shareholder loan may be a distribution or a capital contribution.

After recharacterization of the loan, the term of the loan is determined. Generally, the loan may be either a demand loan or a term loan. The characterization of a loan as either a demand or a term loan determines the method of calculating the interest income and interest expense for the lender and borrower as well as the amount of the additional payment. The timing of these transfers is also determined by a loan's classification as a demand or term loan.

For demand loans, the additional payment (such as a distribution or capital contribution) **equals** the amount of foregone interest transferred to the borrower. Foregone interest is the interest that is deemed to accrue at the AFR that exceeds the interest that actually accrues. This foregone interest is then deemed to be retransferred from the borrower to the lender as interest on the recharacterized loan.

For term loans, the additional payment (such as a distribution or capital contribution) **equals** the amount of the loan that **exceeds** the present value of all payments due under the loan by applying the AFR. This excess is treated as original issue discount (OID) under IRS Code Section 1272. The annual portion of this OID is reported as interest income or interest expense by the parties (S corporation-Shareholder).

Therefore, if the shareholder is the lender, the additional payment is treated as transferred by the lender to the borrowing corporation as capital contribution. (Proposed Regulation Section 1.7872-4(d)(1)). If the corporation is the lender, the additional payment is deemed transferred to the shareholder as a distribution. For S corporations, the distribution is characterized according to IRC Section 1368.

With respect to S corporations, IRC Section 1361(b)(1)(D) states that S corporations are permitted to have only one class of stock. However, differences in voting power among shares are allowed. This rule is different than the rules required for public and private corporations in accordance with Proposed Regulation Section 1.7872-4(d)(2)(ii).

Example B

E is a shareholder of S, an S corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which IRC Code Section 7872 applies. Under Code Section 7872, E is considered to receive a distribution with respect to S stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement. The loan agreement is not a governing provision. Accordingly, S is not treated as having more than one class of stock by reason of the below-market loan to E. (Federal Regulation 1.1361-1(l)(2)(vi), Ex 5.)

A *de minimis* exception (limitation) exists for corporation-shareholder loans. If the total outstanding amount of loans between the lender and borrower in a corporation-shareholder loan is $10,000 or less and tax avoidance is not the main purpose of the loan, IRC Section 7872 rules do not apply. (Proposed Regulation Section 1.7872-9)

17.3.3 Recharacterization of a Demand Loan

Tax Consequences

Demand loans subject to recharacterization are deemed to be **two** transactions (Please see above):

(1) A loan is deemed to occur between the corporation/lender and the shareholder/borrower at the AFR, and

(2) The additional payment to the shareholder/borrower is a distribution determined pursuant to IRC Section 1368.

The **additional payment/distribution** (Transaction 2) equals the foregone interest transferred to the shareholder/borrower. This amount is the **excess** of the amount of the interest payable at the AFR**, over** interest actually payable. S corporation shareholders determine the consequence of the distribution according to IRC Section 1368. The corporation/lender doesn't receive any benefit in the form of a deduction for the distribution.

To service the loan (Transaction 1) with interest, the foregone interest is treated as retransferred from the shareholder/borrower to the corporation/lender. The retransfer of the foregone interest results in interest income (IRC Section 61(a)(4)) for the corporation/lender and interest expense (IRC Section 163(a)) for the shareholder/borrower. (Proposed Regulation Section 1.7872-6(c))

The table below shows how the shareholder/borrower and corporation/lender would report the foregone interest (additional payment) from the demand loan on their tax returns.

	SHAREHOLDER/BORROWER	CORPORATION/ LENDER
INCOME	Distribution (IRC Section 1368) **(Transferred)**	Interest Income (IRC Section 61(a)) **(Retransferred)**
DEDUCTION	Interest Expense (IRC Section 163(a)) **(Retransferred)**	No Deduction benefit for Distribution **(Transferred)**

The shareholder recognizes a distribution in accordance with the IRC Section 1368 rules equal to the amount of the foregone interest. For the shareholder, this is offset by the retransfer of the foregone interest to the corporation resulting in an interest deduction. The corporation gets no deduction for the amount of distribution to the shareholder and recognizes interest income on the retransfer of the foregone interest.

17.3.4 Recharacterization of a Term Loan

Tax Consequences

Term loans subject to recharacterization are deemed to be **two** transactions (Please see above):

(1) A loan is deemed to occur between the corporation/lender and the shareholder/borrower at the AFR, and

(2) The additional payment to the shareholder/borrower is a distribution in accordance to IRC Section 1368.

The **additional payment/distribution** (Transaction 2) equals the amount of the loan that **exceeds** the present value of all payments due using the AFR. (Proposed Regulation Section 1.7872-7(a)). The shareholder/borrower has an IRC Section 1368 distribution equal to this amount. The corporation/lender doesn't benefit from the distribution as no deduction accompanies the distribution.

The amount of the loan that exceeds the present value of all payments is treated as original issue discount (OID) subject to IRC Section 1272 (Transaction 1). The annual part of this OID is reported as interest income by the corporation/lender and interest expense by the shareholder/borrower.

The table below shows how the shareholder/borrower and corporation/lender would report the foregone interest (additional payment) from the term loan on their tax returns.

	SHAREHOLDER/BORROWER	CORPORATION/LENDER
INCOME	Distribution (IRC Section 1368) **(Transferred)**	Interest Income (IRC Section 61(a)) **(Retransferred)**
DEDUCTION	Interest Expense (IRC Section 163(a)) **(Retransferred)**	No Deduction benefit for Distribution **(Transferred)**

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