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S Corporation Elections—Who Decides?

By: Elliot Pisem and David E. Kahen

An S corporation is not subject to Federal income tax (IRC § 1363(a)), and each shareholder's pro rata share of the corporation's items of income, deduction, and credit is taken into account in determining the shareholder's own income tax liability (IRC § 1366(a)). Notwithstanding this "pass-through" treatment, and although an election for a corporation to be an S corporation requires the consent of all of its shareholders (IRC § 1362(a)(2)), elections affecting the computation of items of income, gain, loss, deduction or credit derived from an S corporation are made by the corporation itself (IRC § 1363(c)(1)), except in limited cases involving mining expenditures, foreign taxes, and expenditures that are preference items under the alternative minimum tax.

Setting aside those few exceptions, elections regarding methods of accounting, depreciation, use of the installment method, cancellation of indebtedness income, and other items derived from an S corporation must be made by the corporation; and elections required to be made (if they are to be made at all) by the corporation are applicable to all of its shareholders (Treas. Reg. § 1.1363-1(c)(1)).

Sometimes, an election is desired by one or more shareholders but is not made by an S corporation; or, conversely, an election may be made by the corporation with detrimental results to particular shareholders. A recent Tax Court case, *Caselli v. Commissioner* (TC Memo 2018-81), considers whether a shareholder of an S corporation can effectively nullify an election made by the corporation.

Elliot Pisem and David E. Kahen are partners in the law firm of Roberts & Holland LLP.

Facts in *Caselli*

Ronald Caselli was one of the three shareholders of Apple Gilroy, Inc. (AGI), an S corporation that operated restaurants. Employees of the restaurants received tips from customers. Tips received by restaurant employees from customers are treated, for purposes of the social security (FICA) tax imposed by chapter 21 of the Internal Revenue Code (Code), as "wages" paid to the employees by the employer itself.

Although an S corporation is a pass-through entity that generally does not pay Federal taxes on its own income, the employment tax provisions of the Code apply to S corporations in the same manner as to other corporations. Accordingly, AGI was required (under IRC §§ 3111 and 3121(q)) to treat the restaurant employees' tips as if paid by it to its employees, and to pay the employer's share of the FICA tax attributable to those tips.

Under Code Section 45B, an employer that is required to pay FICA tax with respect to tips received by its employees in connection with serving food or beverages is generally entitled to a federal tax credit equal to a portion of the FICA taxes so paid by the employer (tip credits). However, the employer is precluded from deriving a double tax benefit from such payments: any amount taken into account by the employer in determining the employer's tip credits under Section 45B cannot be claimed by it as a deduction (IRC §45B(c)). Section 45B(d) provides expressly that a taxpayer may elect that section 45B not apply to the taxpayer for a taxable year; it is difficult to imagine any reason that a taxpayer would make such an election except for a desire to be able to claim a deduction for the tip credits.

In the tax years at issue (2006 and 2007), for a reason not apparent from the Tax Court opinion, AGI did not claim any tip credit on its Form 1120S or otherwise. Instead, AGI deducted the FICA taxes attributable to tips on its Forms 1120S filed for those years, and Mr. Caselli's personal tax returns, as originally filed by him, reflected his share of those deductions claimed by the corporation.

In 2010 and 2011, the IRS issued notices of deficiency to Mr. Caselli for 2006 and 2007, respectively.

With respect to each year for which a notice of deficiency was issued, Mr. Caselli made a claim for tip credits with respect to FICA tax paid by AGI. His claim for tip credits with respect to 2007 was first made through the filing of an amended personal tax return in 2011. Mr. Caselli's claim for tip credits for 2006 was first made through the filing of an amended Tax Court petition in 2014, years after filing his initial petitions for Tax Court review of the asserted deficiencies for both years. AGI at no time

filed any amended returns or itself asserted that it wished to credit, rather than to deduct, the FICA taxes it had paid with respect to the employees' tips.

Discussion

After concessions by the parties, the sole issue before the court was whether tip credits were allowable in determining Mr. Caselli's tax obligations. It appears, although not very clearly, from the decision that Mr. Caselli was arguing that (i) if AGI were to claim tip credits by filing amended tax returns, then Mr. Caselli should be entitled to his share of those credits, and (ii) even if AGI did not file such amended returns, Mr. Caselli could claim his share of the tip credits without further action by the corporation or its other shareholders.

The decision observed that the first argument was in substance a request for an advisory opinion based on a condition that might or might not occur in the future, as AGI had not in fact filed amended returns for the years at issue, and there was no other indication that AGI claimed or intended to claim the tip credit. Further, Mr. Caselli had conceded that, by deducting the FICA tax payments, AGI had elected not to claim any tip credit. Although Mr. Caselli asserted that AGI now sought to change its election, the court found that the evidence in the record did not support this assertion.

With respect to whether a shareholder could change an election properly made by the S corporation to waive the tip credit, the court noted that Code section 1363(c) states, in relevant part, that "any election affecting the computation of items derived from an S corporation shall be made by the corporation," and concluded that this language made Mr. Caselli's position untenable. The relevant regulation under Code section 1363 further undermined Mr. Caselli's position, in stating that any elections (other than those specifically reserved for shareholders under the Code) affecting the computation of S corporation items "are made by the corporation and not by the shareholders separately" (Reg. § 1.1363-1(c)(1)).

Finally, Mr. Caselli asserted that any change to the treatment of AGI's items in respect of himself would not affect the other shareholders because of various circumstances specific to them. The decision did not evaluate those assertions, but observed that ruling in Mr. Caselli's favor would "create a new precedent"—a step the court refused to take.

Observations

The refusal of the Tax Court (in the court's words) to "enable the shareholder to nullify the S corporation's election unilaterally and retroactively" is not surprising. It may be a useful reminder that an individual who acquires stock in an S corporation that will not be controlled by that shareholder will be bound by tax elections made by the corporation with which the shareholder may not concur or otherwise consider to be desirable.

It may be possible to foresee, at the time stock is acquired, that differences might arise between the shareholders (or conceivably between the corporation and the shareholders) as to whether or not a specific election should be made. In those cases, consideration should be given to executing a shareholders agreement that addresses specific tax elections that may be made by the corporation or the decision-making process as to tax elections generally.

It should be kept in mind, in this regard, that Code Section 6037(c) specifically requires that the tax return of a shareholder of an S corporation treat each S corporation item in a manner consistent with the treatment of such item on the return of the corporation, unless the shareholder files a notice of inconsistent treatment with the IRS. *See generally* Pisem and Binder, *Lack of Consistency in S Corporation Reporting—How Onerous Are the Results?,* 113 Journal of Taxation 354 (2010).

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