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Deductions for Amounts Paid by S Corporation Shareholders Fall between the Cracks

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Many closely held businesses are conducted through S corporations, which are pass-through entities for Federal income tax purposes, and expenses related to the businesses of such corporations are often paid by owners who also work in the business. Where the individuals providing services are also owners of the business, and payment of expenses is made in a manner roughly proportional to stock ownership, it may not matter to the owners as an economic matter whether the expenses are ultimately reimbursed by the entity to the individual service providers. However, there is an obvious adverse economic consequence if expenses are borne or reported in a manner that precludes deducting them for income tax purposes.

In two recent Tax Court memorandum decisions, the manner of payment and reporting of such expenses resulted in the IRS asserting tax deficiencies based on denial of such deductions, and the IRS positions were sustained in the ensuing court proceedings. The decisions underscore the importance of taking applicable tax rules into account when decisions are being made as to how to incur and report these expenses, with a view to minimizing the potential for such issues to arise on audit.

Vorreyer

In *Vorreyer v. Commissioner* (TC Memo 2022-97), two individuals were the sole stockholders with equal ownership in an S corporation that operated a farm. The individuals (with family members) also engaged in non-corporate farming activity. The corporation's property taxes and utility expenses incurred during 2012 were paid by the two shareholders in proportion to their ownership interests in the corporation. (The opinion does not provide any indication as to why these amounts were not paid by the corporation.)

The individuals claimed business deductions for the property taxes and utility expenses on the Forms 1040 filed by them for 2012, and the Form 1120S filed by the corporation for that year did not claim a deduction for these amounts.

Following an audit of the individuals' tax returns for 2012 through 2014, the IRS determined deficiencies on various grounds, including that the individuals could not deduct the property taxes and utility expenses paid in 2012 on their personal tax returns. The individuals filed petitions for review by the Tax Court, and the parties then filed motions for partial summary judgment on this issue.

The petitioners argued that the payments by them should be considered to be capital contributions to the corporation, and, further, that the corporation was entitled to deduct these expenses. That corporate-level deduction would then reduce the petitioners' distributive shares of income from the corporation, with the same effect as if the deductions reported directly on their individual returns were allowable. The government did not dispute the capital contribution characterization or that the expenses would have been deductible if claimed on the Form 1120S of the corporation. However, the government apparently argued that (i) the individuals were not entitled to a "direct" deduction for these expenses on their personal returns as reported (which the individuals apparently acknowledged), and (ii) the failure to have reported the expenses as deductions on the corporate return precluded allowance of the expenses as a deduction to the corporation.

The court held for the government. Cases cited in the decision support the rule that a shareholder of a corporation is not entitled to a deduction for the payment of an expense of the corporation. (There are exceptions, such as, possibly, an expense paid to promote or protect the shareholders' own business or business reputation, but those did not appear applicable in these circumstances.) Accordingly, the only person (individual or corporation) entitled to a deduction is the person conducting the activity in the course of which the expense was incurred. Although this principle has been established primarily in cases involving C corporations, it is also well-established (on the basis of other case law cited in the decision) that an S corporation remains a separate taxable entity notwithstanding the election under subchapter S and resulting pass-through treatment.

Thus, the failure to report the deduction on the corporate tax return precluded the claiming of the deduction of these expenses in 2012.

There are potential differences between treatment of an expense as a deduction on the return of an S corporation, as opposed to the shareholders' returns, which cause the determination of the person entitled to the deduction to be more than a mere formality, and perhaps these differences influenced the court's view of the case. For example, IRC section 1366(d)(1) limits the flow-through of losses of an S corporation to its shareholder to the sum of the shareholder's basis in stock of the corporation and any indebtedness of the corporation to the shareholder. Nevertheless, the court's conclusion seems harsh.

It is possible that an issue of this nature, if identified early enough during audit of S corporation shareholders, might be successfully addressed, prior to the expiration of the statute of limitations period for the assessment of tax against the shareholders, through the filing of an amended Form 1120S to cause the corporation to claim the deduction (see *Alon International, Inc. v. United States*, 910 F. Supp. 233 (W.D. Pa. 1995)).

Simpson

In *Simpson v. Commissioner* (TC Memo 2023-4), Kyle and Christen Simpson, spouses filing a joint return, owned all of the stock of an S corporation in a software development business. Mr. Simpson was employed by the corporation. On its Forms 1120S for 2011 and 2012, the corporation reported deductions for auto and truck expenses and telephone and home internet expenses (auto and telephone expenses) that were apparently paid by the shareholders personally, but attributable, at least in part, to the business conducted by the corporation.

In 2012, the IRS began an investigation of the tax services provider that had prepared the tax returns of the corporation and its shareholders, and that investigation led to an audit of the tax returns of the S corporation and its shareholders. The notices of deficiency issued after that audit raised issues as to lack of substantiation and improper allocation between activities; they also asserted that the auto and telephone expenses, even to the extent related to the corporation's business, should not have been claimed on the corporate returns and were deductible solely by the shareholders as unreimbursed employee expenses. Such employee-level deductions would be "miscellaneous itemized deductions" subject in the years at issue to the 2% floor imposed by IRC section 67(a). (Under current law (and IRC section 67(g) in particular), miscellaneous itemized deductions are not deductible to any extent.)

In ensuing proceedings before the Tax Court, the shareholders continued to assert that the auto and telephone expenses were properly deducted by the corporation.

The opinion observed that a corporation (including an S corporation) is treated as an entity separate from its shareholders. Thus, the payment of a corporate obligation by its shareholder does not generally result in a deduction to the shareholder, though it may be deemed a contribution to the capital of the corporation, which amount may then be deductible by the corporation.

It is not clear from the discussion in the opinion whether the petitioners expressly argued that the payment of auto and telephone expenses should be deemed capital contributions to the corporation, though their intent to treat these amounts as capital contributions was perhaps implied by the claiming of the deductions on the return of the corporation. The discussion in the decision suggests that the court might have been more inclined to treat the payments as contributions if there had been evidence that the corporation was under a legal obligation to make these payments.

The shareholders argued that the corporation maintained an “accountable plan,” within the meaning of Treasury Reg. section 1.62-2(c)(2). Such a plan provides for reimbursement by an employer of expenses incurred by its employees in connection with their performance of services on behalf of the employer. In order to achieve the desired tax results for an accountable plan, the plan must satisfy conditions regarding substantiation, business connection of the expense to the employer's business, and return to the employer of any payments in excess of substantiated expenses actually paid by employees.

If there had been an accountable plan in the situation before the court, amounts reimbursed by the employer under the plan would not have been includible in the income of the employees, and any expense for which reimbursement was made would generally be deductible by the corporation. However, the court concluded that there was neither a written accountable plan nor credible evidence of the existence of an unwritten accountable plan, such as a pattern where documentation of such expenses was provided by the employees to the corporation, with reimbursement being made thereafter in the exact amount of the expenses.

Further, although there had been transfers from the account of the corporation to the personal accounts of the shareholders, there were no records identifying each such transfer as a distribution or a reimbursement.

The court concluded that the shareholders had failed to establish the existence of an accountable plan, and, consequently, that the auto and telephone expenses must be considered unreimbursed employee expenses, allowable solely as miscellaneous itemized deductions on the shareholders’ tax returns.

Observations

The opinion in *Simpson* observed that it found Mr. Simpson's testimony to be unpersuasive in certain respects, and the opinion refers, in the discussion of penalties asserted by the IRS and contested by the shareholders, to the petitioners' "cavalier approach to deductions." It also appears that the amounts involved in respect of the auto and telephone expenses were relatively small. These circumstances suggest that caution is appropriate in attempting to infer a broad principle of non-deductibility from the failure of the court in *Simpson* to consider expressly whether the auto and telephone expenditures should have been deemed capital contributions to the corporation and deductible by it.

Notwithstanding the above, *Vorreyer* and *Simpson* serve as reminders that the path to the deduction of any particular expense may often be easier if the expense is paid directly by the entity that is expected to claim the related deduction, rather than by an owner or affiliate. Where direct payment by the person expected to claim the deduction is not practicable, and the expenditure is paid by an owner, consideration should be given to documenting, before or contemporaneously with payment, that the expenditure was undertaken as a capital contribution to the entity and to discharge an obligation of the entity, or (in the employment context specifically) made by an employee under an accountable plan and subject to reimbursement by the employer.

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