Larry's Tax Law

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part XIV - An S Corporation Is Not Always a Mere Extension of Its Shareholders

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In this Part XIV of my multi-part series on some of the not-so-obvious aspects of Subchapter S, I explore a narrow aspect of Subchapter S that is often ignored or forgotten. An S corporation is not always a mere extension of its shareholders.

Because of the pass-through nature of Subchapter S, taxpayers and their advisers often conclude that an S corporation is a mere extension of its shareholders. That is not always the case. A 2012 decision of the U.S. Tax Court provides a good illustration of this point.

Trugman v. Commissioner

In *Trugman v. Commissioner*, 138 TC 22 (2012), the Tax Court was presented with a married couple, the Trugmans. Jack Trugman, an engineer and business consultant, and his wife, Joan Trugman, resided in California. They decided to move and establish residency in Nevada, primarily because it has no state income tax.

The Trugmans were the sole shareholders of Sanstu Corporation ("Sanstu"), a Wyoming Corporation that had an S election in effect. Sanstu owned rental real estate located in Missouri, Texas and California.

Upon moving to Nevada in 2009, the Trugmans caused Sanstu to purchase a single-family dwelling. Sanstu contributed $319,200 toward the purchase price, and the Trugmans contributed $7,500 toward the purchase price. The deed to the home reflected Sanstu as the sole, fee simple owner.

The Trugmans moved into the dwelling and made it their personal residence. They had not owned a personal residence during the three (3) immediately preceding tax years.

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On their 2009 IRS Form 1040, the Trugmans claimed an $8,000 tax credit as a first-time homebuyer under IRC § 36. The credit was not claimed on Sanstu's 2009 IRS Form 1120S.

The IRS disallowed the credit. After losing at audit and on appeal, the Trugmans filed a petition in the U.S. Tax Court. They were represented *pro se* in the court proceeding.

The issue presented to the court, an issue of first impression, was simple -

Whether an individual may claim the tax credit under IRC § 36 for a principal residence purchased by his/her wholly-owned S corporation. Put another way, for purposes of IRC § 36, was Sanstu a mere extension of the Trugmans, the sole shareholders of Sanstu?

Under IRC § 36, a refundable tax credit was allowable (now expired) to a first-time homebuyer of a principal residence. IRC § 36(a) defines a first-time homebuyer as an "individual" who had no present ownership in a principal residence during the three (3) year period ending on the date the principal residence for which the credit is claimed was purchased.

An S corporation does not qualify as an individual. Judge Kroupa, who presided over the proceeding, concluded consistently - a corporation is not an individual. An S election does not alter that conclusion.

In addition, Judge Kroupa noted, the credit applies to the purchase of a principal residence, the primary place where a person lives. While a corporation has a principal place of business, it does not have a principal residence. Accordingly, the court held that the Trugmans could not claim the first-time homebuyers' tax credit for the home purchased by their wholly-owned S corporation. For this purpose, the S corporation was not a mere extension of its shareholders.

The Trugmans pleaded with the court for leniency. They claimed an IRS representative verbally advised them that they could claim the credit even if their S corporation acquired the residence. Citing several cases, including *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), the court stated the long-standing rule of law - incorrect legal advice received by a taxpayer from an IRS representative "does not have the force of law and cannot bind the Commissioner [of the IRS] or this Court." The Code, Treasury Regulations and judicial decisions govern a taxpayer's tax liability. So, with its plea for leniency denied, the Trugmans' claim for the first-time homebuyers' credit was found improper.

The *Trugman* decision should equally apply if Sanstu had attempted to claim an exclusion under IRC § 121. IRC § 121 allows a taxpayer to exclude up to $250,000 ($500,000 for certain taxpayers who file a joint return) of the gain from the sale (or exchange) of property owned and used as a principal residence by the taxpayer for at least two (2) of the five (5) years before the sale. A taxpayer can claim the full exclusion only

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once every two (2) years. A reduced exclusion is available to anyone who does not meet these requirements because of a change in place of employment, health or certain unforeseen circumstances. As the court explained in *Trugman*, a corporation does not have a principal residence. Accordingly, it would not be accorded exclusion treatment under IRC § 121. The S corporation, for purposes of IRC § 121, is not a mere extension of its shareholders.

Conclusion

For purposes of pass-through taxation, an S corporation is generally a mere extension of its shareholders. For other purposes, however, as illustrated by *Trugman v. Commissioner*, that is not always the case.

Stay tuned for more blog posts in my multi-part series on some of the not-so-obvious aspects of Subchapter S.

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